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No. 91-___

In The

Supreme Court of the United States

October Term, 1991

SOL FINKELMAN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a taxpayer who acquires income-producing property subject to a contemporaneous nonrecourse indebtedness with a face amount that exceeds the property's fair market value may deduct depreciation and accrued interest attributable to a portion of the nonrecourse indebtedness that corresponds to the fair market value of the collateral.

2. If a taxpayer's property acquisition is disregarded for tax purposes, does 26 U.S.C. § 6659 allow the Internal Revenue Service to automatically impose the overvaluation penalty at the maximum rate rather than employing the statutory graduated rates?

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PETITION FOR WRIT OF CERTIORARI

Petitioner, Sol Finkelman petitions for a writ of certiorari to review the decision of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The memorandum opinion of the United States Tax Court ("Tax Court") is reported at ¶89,072 P-H Memo T.C. and is also reprinted at Appendix A, App. pp. 1-69. The unpublished order of the Tax Court denying Petitioner's motion for leave to file a motion for rehearing is reprinted at Appendix B, App. pp. 70-71. The unpublished memorandum of the Court of Appeals for the Ninth Circuit affirming the Tax Court memorandum opinion is reprinted at Appendix C, App. p. 72. The unpublished order of the Court of Appeals denying Petitioner's petition for rehearing is reprinted at Appendix D, App. p. 73.

JURISDICTION

The opinion of the Court of Appeals affirming the Tax Court was filed on July 10, 1991. A petition for rehearing was denied on September 11, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1). This petition for writ of certiorari is filed within the 90-day period prescribed by 28 U.S.C. § 2101(c) as computed in accordance with Rule 13.4 of the Rules of the Supreme Court of the United States.

STATUTES INVOLVED

The Internal Revenue Code of 1954 (26 U.S.C. (1976), also referred to as "I.R.C."), as in effect for the years 1977-1982, provided in pertinent part:

§ 163. Interest.

(a) General rule.

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

§ 167. Depreciation.

(a) General rule.

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * *

(g) Basis for depreciation.

The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

§ 1011. Adjusted basis for determining gain or loss

(a) General rule.

The adjusted basis for dete.mining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

§ 1012. Basis of property – cost.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

§ 6659. Addition to tax in the case of valuation overstatements for purposes of the income tax[1]

(a) Addition to the tax. – If –

(1) an individual, or

(2) a closely held corporation or a personal service corporation,

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[1] I.R.C. § 6659 is effective for returns filed after December 31, 1981. Thus, as to the years at issue, it only applies to Petitioner's 1981 and 1982 tax years.

has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

(b) Applicable percentage defined. – For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation –	The applicable percentage is:
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

(c) Valuation overstatement defined. –

(1) In general. – For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

(2) Property must have been acquired within last 5 years. – This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

(d) Underpayment must be at least $1,000. – This section shall not apply if the underpayment for the taxable year attributable to valuation overstatements is less than $1,000.

(e) Authority to waive. – The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that such claim was made in good faith.

(f) Other definitions. – For purposes of this section –

(1) Underpayment. – The term "underpayment" has the meaning given to such term by section 6653(c)(1).

(2) Closely held corporations. – The term "closely held corporation" means any corporation described in section 465(a)(1)(C).

(3) Personal service corporation. – The term "personal service corporation" means any corporation which is a service organization (within the meaning of section 414(m)(3)).

STATEMENT OF CASE

Petitioner, an accountant and financial advisor by trade, also located and acquired commercial real estate for his own account and for clients who were interested in real estate investments. The instant litigation involves properties acquired from Joseph and Grace Penner (the "Penners") by eight such investment partnerships (the

"Partnerships") formed by Petitioner and other investors between 1977 and 1981.[2]

All of the properties considered by the Courts below (the "Properties")[3] were acquired with long-term nonrecourse seller financing (the "Notes") plus "down payments" in the form of cash and short-term recourse notes constituting from 10.6% to 21.1% of the total stated purchase price of each Property. Interest accrued on each Note at just below market rate for three years (10% to 15% depending on when the relevant Property was acquired), and thereafter decreased to substantially less than market rate (5% to 6.5%). The parties agreed on an appropriate cash purchase price for each Property which was then adjusted upwards to reflect the value of this very favorable seller financing.

Payments on each nonrecourse note were to be paid from Property rentals and balloon payments commencing as early as 15 years after closing, but, for the most part, due at termination of the Note (anywhere from 21 to 29 years after closing). Most of the Notes also involved a small amount of "negative amortization" (*i.e.*, the monthly payments were insufficient to cover the interest accruing on principal).

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[2] In certain cases the properties were acquired by petitioner, individually, on behalf of the Partnerships.

[3] Pursuant to a stipulation of the parties, the Courts below only considered five of the various properties acquired by the Partnerships as representative in an attempt to obviate the need for further litigation concerning each property owned by the eight Partnerships.

Each Parnership always used its Property's stated purchase price to compute depreciation for federal income tax purposes. Likewise, as an accrual basis taxpayer, each Partnership deducted all interest as it accrued according to the terms of its Note(s). For all the years in question (those through 1982), each Partnership's federal tax return showed net losses attributable to its investment in its properties, which net losses were reflected on the various partners' Form K-1s. Petitioner duly entered these Form K-1 losses on his individual federal income tax returns for these years (Form 1040).

The Respondent issued notices of deficiency disallowing all Petitioner's Partnership net losses for these years. These notices of deficiency claimed the Partnerships' properties were all worth substantially less than their stated purchase price, and, therefore, the Partnerships had not substantively purchased those properties. The Respondent also asserted penalties for negligence and valuation overstatement under 26 U.S.C. §§ 6653(a) and 6659 (now 26 U.S.C. §§ 6662(b)(1) and (b)(3)), respectively, as well as imposing interest at the rate prescribed in 26 U.S.C. § 6621(c) [since repealed] for deficiencies attributable to "tax motivated transactions" (120% of the otherwise applicable statutory rate established under 26 U.S.C. § 6621(b)).

Petitioner responded to these notices of deficiency with timely petitions to the Tax Court, Docket Nos. 7581-86 and 34999-86, contesting the full amount of Respondent's claimed deficiencies, as well as all penalties and application of the interest rate of 26 U.S.C. § 6621(c). The Tax Court had jurisdiction pursuant to I.R.C. §§ 6213(a), 6214(a) and 7442. In Tax Court Petitioner

argued either that (i) the Partnerships had, indeed, paid fair market value because the favorable under-market seller financing negotiated by the Partnerships increased the properties' fair market value to the Partnerships, or (ii) that the fair market value of the Notes given as consideration for the purchase price equaled the value of each acquired Property. That is, the Petitioner argued that: (a) a purchaser is willing to pay a premium purchase price for below-market seller financing; and (b) that the stated purchase price the Partnerships paid for the Properties merely reflected that premium.

Nonetheless, the Tax Court, in a memorandum opinion dated February 16, 1989 by the Honorable Joel Gerber, held that the fair market value of the Properties must be segregated from the concept of financing the purchase, and the favorable financing terms did not affect the Property values for federal tax purposes. Thus, Judge Gerber found that, in each case, both the Property's stated purchase price and the face amount of the underlying nonrecourse Note(s) exceeded the Property's fair market values. The Tax Court did not make any determination of the value of the consideration (*i.e.*, the Notes with a below-market interest rate) paid for the Properties despite the fact that, because of the below-market interest rates, the value of these Notes was less than their face amount. Citing *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), Judge Gerber then held that, as a matter of law: there was no investment in the Properties; and, because the purchase prices were excessive, the Notes did not constitute genuine indebtedness. The Tax Court accordingly held that no deductions could be allowed for either depreciation on the Properties or interest paid or accrued on the Notes.

Judge Gerber also held that, because Petitioner's favorable financing argument had some support in the case law, the negligence penalty would be inappropriate. However, since they had not, in fact, acquired the Properties for federal income tax purposes, the Partnerships had no (*i.e.*, a zero) adjusted basis in such Properties. Thus, even though the Properties' stated purchase prices were only 39% to 72% over the court-found values (which would appear to render the overvaluation penalty under I.R.C. § 6659 inapplicable to one of the Properties and applicable at a 10% rate to the other four Properties), Judge Gerber applied the penalty at the (then) maximum 30% rate reserved for valuations exceeding 250% of the fair market value. This holding was modified, however, to eliminate the penalty for those Partnership tax years in which the Partnerships had held the Properties five years at the close of the year. 29 U.S.C. § 6659(c)(2) [since repealed].

Finally, Judge Gerber held that, since the Petitioner's investment in the Partnerships lacked economic substance and also involved a valuation overstatement, the 120% interest rate of 26 U.S.C. § 6621(c) was applicable.

On June 22, 1989, Petitioner filed a motion for leave to file a motion for reconsideration seeking, *inter alia*, consideration of the effects of *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263, 273-77 (3d Cir. 1988), *reh'g denied*, 863 F.2d 277 (3d Cir. 1989), *cert. denied*, 493 U.S. 901 (1989) (reprinted at App. E at pp. 74-114), a case decided after the briefs were filed in this case. The *Pleasant Summit Land Corp.* case rejected the Tax Court's rule of completely disregarding the acquisition in cases involving nonrecourse financing substantially in excess of the property value. Instead, the court held that in such cases the

purchase price should be reduced to equal any cash down payment plus the fair market value of the underlying collateral. While recognizing that *Pleasant Summit Land Corp.* might have an effect on the holding in Petitioner's case, Judge Gerber nonetheless executed an Order on August 3, 1989, denying Petitioner's motion.

Pursuant to I.R.C. § 7482(a), Petitioner then filed a timely appeal from the Tax Court decision with the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit"), Docket No. 90-70050. On appeal the Petitioner attacked the Tax Court's determination that the Partnerships' purchase prices were excessive and that the purchases lacked economic substance. Also, Petitioner again argued that, even if the face amount of the non-recourse Notes exceeded the Properties' fair market value, the purchase should not be disregarded in its entirety, but rather the purchase price should be treated as reduced for federal tax purposes to reflect the actual value of the underlying consideration, *i.e.*, any cash paid plus the value of the underlying Properties. Petitioner also argued that the overvaluation penalty is inapplicable to cases where the court finds there was no acquisition for tax purposes. On July 10, 1991, by an unpublished memorandum, the Ninth Circuit affirmed the judgment of the Tax Court "for the reasons set forth in that court's February 16, 1989 memorandum opinion."

On July 23, 1991, Petitioner filed a petition for rehearing with the Ninth Circuit, arguing only the overvaluation penalty issue, citing inconsistency with another recent Ninth Circuit case, *Vorscheck v. Commissioner*, 993 F.2d 757 (9th Cir. 1991), and, alternatively, that even if applicable, the penalty should only be applied on the ratio of actual value to value claimed, not on the ratio of

an artificial zero adjusted basis to value claimed. On September 11, 1991, the Ninth Circuit denied Petitioner's petition for rehearing.

REASONS FOR GRANTING THE PETITION

I. Petitioner Should Have Been Allowed Depreciation and Interest Deductions Based Upon the Fair Market Value of the Properties

The courts below concluded that, where the face amount of purchase money nonrecourse debt exceeds the value of the property being acquired, there is no purchase for tax purposes. In so holding, these courts have decided an important question of federal tax law incorrectly. While pinning this conclusion on economic realities, these courts ignore the fact that adjusting the price to reflect the actual fair market value of what was acquired better reflects reality than ignoring the acquisition altogether. That is, the parties are much more likely to restructure debt to reflect the property's value than to allow an actual foreclosure to take place. The decision of the courts below also directly conflicts with that in *Pleasant Summit Land Corp.* In that case the Court of Appeals for the Third Circuit held that, if the face amount of nonrecourse financing exceeds the value of the acquired property, these same economic realities mandate that the tax basis of the property must be adjusted to reflect the sum of any down payment plus the fair market value of the collateral. The resulting conflict between the circuits is critical to the tax treatment of leveraged real property purchases.

As such it is so broad in its reach as to create grave and unseemly inequities in federal tax administration.

1. In major part, what is at issue are the deductions taken by the Partnerships for depreciation on their Properties and for interest on the Notes. Respecting the deductions for depreciation, I.R.C. § 167(a) provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in [taxpayer's] trade or business, or * * * held for the production of income." I.R.C. § 167(g) provides that the taxpayer's basis for calculating depreciation shall be the same as the adjusted basis of the property for purposes of determining the gain on a sale or other disposition of the property, as defined in I.R.C. § 1011. That section, in turn, references I.R.C. § 1012, which requires the taxpayer to use the cost of the property as his/her basis, subject to certain irrelevant exceptions and adjustments. The "cost" of property is defined in Treas. Reg. § 1.1012-1(a) as "the amount paid for such property in cash or other property."

Since "other property" within Treas. Reg. § 1.1012-1(a) includes, for example, the purchaser's indebtedness, the cost of property includes the value of indebtedness incurred or assumed by the purchaser as part of the purchase transaction. This is true even where the debt is nonrecourse. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947). Further, several Courts of Appeals have held that nonrecourse debt in excess of the acquired property's fair market value is excluded from the cost of property for purposes of computing the depreciation deduction. *E.g., Odend'hal v. Commissioner*, 748 F.2d 908, 912-14 (4th Cir.

1984), *cert. denied*, 471 U.S. 1143 (1985); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976).

The deductions for interest accrued on the Notes are governed by I.R.C. § 163(a), which allows taxpayers to deduct "all interest paid or accrued within the taxable year on indebtedness." This includes nonrecourse indebtedness. However, a precondition for deductibility is that there be a valid and enforceable obligation requiring the payment of both principal and interest. *Knetsch v. United States*, 364 U.S. 361, 365-66 (1960). Here the Notes are all nonrecourse obligations, *i.e.*, debt for which the debtor has no personal obligation to repay, but for which repayment is protected by a collateral interest in the underlying property. In such instances, the taxpayer only has an incentive to repay the loan to the extent the loan does not exceed the value of the underlying security. Thus, the cases have only considered nonrecourse loans to give rise to genuine indebtedness to the extent the value of the property is at least equal to the amount of the debt. As the Court of Appeals for the Fourth Circuit states in *Odend'hal v. Commissioner*, at 748 F.2d 912:

> When the debt is a nonrecourse loan, the principal amount of the loan is included in the taxpayer's basis so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral. But if the stated price financed by nonrecourse debt exceeds the fair market value of the property, **to the extent of the excess**, the taxpayer has no equity in the property to protect

> and no economic incentive to pay off the debt. (Citations omitted.) (Emphasis supplied.)

In the instant case the Tax Court and then the Ninth Circuit ruled that, as a matter of law, where nonrecourse financing unreasonably exceeds the value of the underlying security, both the purchase and the nonrecourse financing must be disregarded in their entirety. App. A at pp. 42-46, 61, 64; App. C at p. 72. Thus, since there is no purchase, there is no depreciable cost basis; and, since there is no genuine debt, there are no allowable interest deductions. *Id.* According to both Courts, this result was required by economic reality and precedent. *Id.* Neither rationale bears scrutiny.

Economically, it is true that a nonrecourse borrower has no economic incentive to repay more debt than the value of the property. However, it is equally true that same debtor has every incentive to settle the debt up to the value of the property (as opposed to losing the property altogether). And, by the same token, while the creditor has reason to insist on debt repayment equal to the property value, that creditor has no economic leverage to compel payment of more than the property's value. That is, the creditor is unlikely to want the property back if he can get the debtor to pay at least the property's value; and , alternatively, a foreclosure sale to the highest bidder would be highly unlikely to produce more than market value, and actually apt to produce less.

Further, this analysis accords with what is likely to occur in fact. To conclude, as the courts below have, that no real purchase has taken place is to conclude the parties expect foreclosure from the outset. This runs contrary to

reality. Most sellers, even those in "tax shelter" situations, have neither the desire nor the expectation of ever taking back the property. And even "tax shelter" buyers recognize that a foreclosure has adverse ramifications, such as expense, economic forfeiture and tax recapture. Rather, both parties recognize from the outset that a debt restructure to account for the property's value almost always makes much better economic sense to both parties than foreclosure.

Thus, the economic reality is that nonrecourse debt in excess of the underlying property value amounts to a commitment of the debtor to pay the nonrecourse debt up to the property's value and an effective agreement by the creditor to be satisfied with that amount.

> Thus, it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded.

Pleasant Summit Land Corp., App. E at p. 108.

Put another way, while the **face amounts** of the Notes may have been too high, their **economic value** reflected the value of the Properties being acquired. Under Treas. Reg. § 1.1012-1(a), the amount paid for the Properties is the amount of cash plus **the value** of the Notes, which, in turn, equaled the value of the Properties. Thus, the purchases should not have been disregarded in their entirety, rather the courts below should have accepted the purchases, but discounted the face amount of the purchase Notes to reflect their true value (and the value of the

Properties being acquired). *Pleasant Summit Land Corp.* demands no less.

Ninth Circuit precedent is not to the contrary. Both lower courts placed primary reliance on *Estate of Franklin v. Commissioner.* App. A at pp. 41-46, 57, 61, 64; App. C. at p. 72. It is true that *Estate of Franklin* stands for the rule that full depreciation and interest deductions will not withstand scrutiny when the face amount of nonrecourse financing unreasonably exceeds the acquired property's value. *Estate of Franklin v. Commissioner* at 544 F.2d 1048-49. However, as explained on rehearing in *Pleasant Summit Land Corp.*, App. E at p. 112:

> We observe, however, that in both *Odend'hal* and *Estate of Franklin*, as the Commissioner seems to acknowledge, the issue of whether the taxpayers were entitled to a partial deduction was apparently not raised either before the Tax Court, *see Odend'hal v. Commissioner*, 80 T.C. 588, 590, 602-05, 617-18 (1983); *Estate of Franklin v. Commissioner*, 64 T.C. 752, 760-62, 770-71 (1975), or on appeal, *see Odend'hal*, 748 F.2d at 909, 912, 913; *Estate of Franklin*, 544 F.2d at 1046, 1048-49.

In fact, Petitioner is aware of no other Ninth Circuit case, and no case at all before *Estate of Isaacson v. Commissioner*, 860 F.2d 555 (2d Cir. 1988) which directly considers "partial disallowance" (*i.e.*, disallowance of only the excess of nonrecourse debt over the acquired property value).

Moreover, the analysis employed in cases such as *Estate of Franklin* and *Odend'hal* is an economic analysis similar to that discussed above, which supports Petitioner when adapted to consider a "partial disallowance" claim. In fact, at least the Court of Appeals for the Third Circuit

agrees that these cases constitute "precedent for disallowing deductions based on nonrecourse debt only insofar as attributable to the excess of debt over the fair market value." *Pleasant Summit Land Corp.*, App. E at 108. *See also Pleasant Summit Land Corp., on reh'g*, App. E at pp. 112-13.

Thus, not only is the analysis of the Courts below flawed, but the very factors upon which that analysis relies actually mandate that the decision is incorrect.

2. The decision below is also in direct conflict with *Pleasant Summit Land Corp.* There, a partnership acquired a real estate project for $7,759,200. At least $7,259,200 of that acquisition price was nonrecourse debt, and the underlying property was found to be worth no more than $4,200,000. The Tax Court found the nonrecourse debt unreasonably exceeded the property's fair market value, and on that basis, denied all deductions for depreciation and interest. The Third Circuit reversed as follows:

> While we regard *Odend'hal* and *Estate of Franklin* as the appropriate precedents, we do not consider them as authority to eliminate all deductions for interest and depreciation. While we realize that a taxpayer holding property subject to a nonrecourse debt in excess of the market value of the property may have no incentive to pay off any portion of the debt, including the amount not exceeding the fair market value of the property, it is equally logical to recognize that the creditor holding the debt has no incentive to take back the property if the taxpayer offers to pay the debt up to the value of the property. For example, if a creditor held a nonrecourse debt for $1,500,000 on a property with a fair market value of $1,000,000, he would have

> a disincentive to foreclose if his defaulting debtor offered to settle the debt for not less than $1,000,000. Thus, it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded. Moreover, there is precedent for disallowing deductions based on nonrecourse debt only insofar as attributable to the excess of debt over the fair market value. *See Odend'hal*, at 748 F.2d 912-14.

App. E at p. 108.

In the instant case, the issue of limiting the disallowed depreciation and interest deductions to the excess of nonrecourse debt over property value was raised to both Courts below.[4] In affirming the Tax Court's complete disallowance of Petitioner's depreciation and interest deductions the Ninth Circuit clearly took a position

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[4] The Third Circuit opinion in *Pleasant Summit Land Corp. v. Commissioner* was filed well after the trial and submission of briefs in the petitioner's Tax Court case. However, the petitioner brought the "partial disallowance" issue and the potential applicability of *Pleasant Summit Land Corp.* to the attention of the Tax Court in petitioner's motion for leave to file a motion for rehearing. Judge Gerber took recognition of the potential applicability of *Pleasant Summit Land Corp.* to petitioner's case, but nonetheless decided to deny petitioner's motion. Petitioner also specifically argued the "partial disallowance" theory in its appeal to the Ninth Circuit.

directly at odds with the position of the Third Circuit as expressed in *Pleasant Summit Land Corp.*[5]

3. The decision below, in addition to being erroneous, exacerbates a conflict between the circuits which is critical to the tax treatment of leveraged real property purchases; and, if permitted to stand, this conflict will produce grave inequities in the tax administration of real estate tax shelters. Petitioner understands that there are still a large number of unsettled real estate tax shelters, aggregating more than $600,000,000 in claimed deficiencies which could be allowed or disallowed depending solely upon the circuit in which the case is brought. The resulting potential for disparities in tax treatment can be dramatic, recognizing that currently the Third Circuit answers the question one way, the Second and Ninth Circuits answer directly to the contrary, the Fifth Circuit answers a third way, and the remaining circuits have not yet answered the question at all.

Because tax advantaged partnerships are often marketed to investors living in different judicial circuits, the

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[5] In addition, two other Courts of Appeals have also considered the issue. The Second Circuit appears to agree with the Ninth Circuit. *See, Lebowitz v. Commissioner*, 917 F.2d 1314, 1318-19 (2d Cir. 1990); *Estate of Isaacson v. Commissioner*, at 860 F.2d 56. By contrast, the Fifth Circuit indicated, in dictum, that it might be receptive to a "partial disallowance" argument under certain circumstances, such as when it could be shown the creditor has no wish to reacquire the property and the debtor, in fact, wishes to keep the property. *Lukens v. Commissioner*, 945 F.2d 92, 98-99 (5th Cir. 1991). However, the Fifth Circuit also refused to follow *Pleasant Summit Land Corp.* and allow a partial deduction in a situation where the underlying property had only "dubious utility." *Id.*

existence of a different rule for the calculation of the depreciation and interest deductions allowable to investors in the same partnership residing within different circuits would produce unseemly confusion and inconsistency. The Partnerships, themselves, produce a perfect example. It is therefore appropriate for this Court to grant certiorari to correct the error of the courts below and to establish a uniform rule to govern the recurrent fact pattern of this case.

II. The Ninth Circuit Incorrectly Applied the I.R.C. § 6659 Overvaluation Penalty at the Maximum 30% Rate

The Court of Appeals' decision ignores statutory safeguards enacted to limit the egregious application of I.R.C. § 6659. I.R.C. § 6659 imposes an addition to tax based upon a graduated scale; the more severe the valuation overstatement, the more severe the addition to tax ("penalty"). Because the Courts below disregard this safeguard, their decision results in a blanket application of the maximum overvaluation penalty, regardless of the severity of the overvaluation.

The maximum penalty may only be imposed in the most severe valuation overstatements. A valuation overstatement exists if the value of any property, or the adjusted basis of any property, claimed on any return equals or exceeds 150% of the correct amount of the value or adjusted basis (as the case may be). I.R.C. § 6659(c)(1). Neither the statute nor the regulations indicate when "value," rather than "adjusted basis" of the property is used to calculate the valuation overstatement. As to the

years at issue, the following penalties were applicable under I.R.C. § 6659(b):

If the valuation claimed is the following percentage of the correct valuation –	The penalty is the following percentage of the resulting tax underpayment:
150% or more but not more than 200%	10%
More than 200% but not more than 250%	20%
More than 250%	30%

In *Finkelman v. Commissioner*, ¶ 89,072 P-H Memo T.C., *aff'd*, 937 F.2d 612 (9th Cir. 1991), the Tax Court examined the five Partnership Properties and concluded that the stated purchase prices ranged from 39% to 72% more than their fair market value. App. A at p. 56. In addition, the court found that the price to fair market value ratios were not "inherently egregious." *Id.* Nonetheless, a 30% penalty was upheld by the court. *Id.* at 66.

The Tax Court reasoned that each Partnership claimed an adjusted basis on its return equal to the stated purchase price. Since no sales were recognized for tax purposes, the court further found that the correct adjusted bases were considered to be zero and, therefore, each overvaluation would exceed 250%. *Id. Compare, Gilman v. Commissioner*, 933 F.2d 143 (2nd Cir. 1991), petition for certiorari filed October 15, 1991.[6]

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[6] In *Gilman*, the taxpayer argued that the I.R.C. § 6659 penalty was totally inapplicable because he couldn't overvalue an asset he was found not to have purchased. *Id.* at 150-51. Although the court acknowledged that applying the penalty somewhat strained the reading of the statute, the court nonetheless applied the penalty using a zero basis. *Id.* However, the

(Continued on following page)

In situations like *Finkelman*, the use of zero as the adjusted basis of the property is incorrect. The value of the Property must be used to satisfy the intent of the statute. The original intent of I.R.C. § 6659 was to adopt a "bright line" test to determine the significance of a valuation overstatement (H.R. Rept. No. 97-201, 97th Cong., 1st Sess. § 243 (1991)); hence, a sliding scale was used to determine the severity of the penalty. In the case of a sale which is not recognized for tax purposes, such as *Finkelman*, the application of the sliding scale is simple and straightforward. And, while the application of a flat 30% penalty in the case where property is not deemed purchased would also be simple and straight forward, it would effectively ignore the sliding scale adopted by Congress to implement the statute.

Accordingly, appropriate application of the sliding scale in I.R.C. § 6659 is aptly designed to reflect the role valuation plays in determining when a sale has taken place for tax purposes. To illustrate, one factor which indicates whether a sale takes place for tax purposes is whether the taxpayer has paid more than fair market value for the property. *E.g., Estate of Franklin*, at 544 F.2d 1048. As in such cases, the Court determines a fair market value for the "overvalued" property. The more flagrant the overvaluation, the greater the likelihood that the overvaluation is a contributing factor to finding that no

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issue in *Gilman* was whether a disregarded sale constituted a valuation overstatement under I.R.C. § 6659(c)(1), not whether to use value or basis as to the measurement of the penalty rate under I.R.C. § 6659(b). As such, *Gilman* is inapplicable to the situation in *Finkelman*.

sale took place for tax purposes. Conversely, the opposite is true. If the overvaluation is relatively insignificant, it will be an insignificant factor in finding whether a sale took place for tax purposes.

The *Finkelman* court, however, has overlooked this statutory intent. Under the Court's decision, the Court does not allow the scale to slide, and instead, permanently weights it against the taxpayer. The penalty is no longer based on the degree of the taxpayer's valuation overstatement, but serves as a blanket 30% penalty that applies anytime a sale is not recognized for tax purposes. This is contrary to the purpose of I.R.C. § 6659.

CONCLUSION

For the reasons set forth above, a writ of certiorari should be granted.

DATED: December 10, 1991.

Respectfully submitted,

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APPENDIX A

UNITED STATES TAX COURT

SOL FINKELMAN, Petitioner,	)	Docket No. 7581-86 No. 34999-86
v.	)	Judge Joel Gerber
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	(Filed Feb. 16, 1989)

Official Report

Marvin J. Garbis and L. Paige Marvel, for the petitioner.

Mary Schewatz, Steve Mather and Thomas Coker, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, *Judge:* Respondent, in statutory notices of deficiency as identified below, determined deficiencies and additions to petitioner's income taxes as follows:

Notice of Deficiency	Year	Income Tax Deficiency	Additions to Tax Sec. 6651(a)(1)[2]	Sec. 6653(a)	Sec. 6659
1/30/86	1975	$ 9,035	$ 1,980	507	$ –
1/30/86	1976	70,535	17,634	3,587	–
–	1977	120,787	30,093	6,177	–
–	1978	315,368	–	15,768	–
6/16/86	1979	96,156	20,878	4,808	–
6/16/86	1980	129,051	23,281	6,453	–
–	1981	243,919	–	12,196*	33,603
–	1982	91,571	–	4,579*	23,078

[2] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

* Pursuant to section 6653(a)(1), plus 50 percent of the interest on the deficiencies pursuant to section 6653(a)(2).

After concessions, the issues remaining for our consideration involve petitioner's real estate investment activity. The specific issues to be considered are: (1) Whether petitioner should be allowed claimed losses related to certain real estate transactions; (2) whether petitioner should recognize gross income attributable to partnership interests received for services; (3) whether the section 6653(a) addition to tax applies to any underpayments; (4) whether petitioner is liable for additions to tax pursuant to section 6659; and (5) whether petitioner is liable for increased interest on tax motivated transactions under section 6621(c).

FINDINGS OF FACT

This is a "lead" case of a related group of taxpayers who invested in and claimed tax benefits regarding certain real estate partnerships formed and managed by petitioner, Sol Finkelman. Respondent determined adjustments with respect to 17 of the partnerships. Adjustments involving eight of the partnerships are still at issue, and these will be resolved, by agreement of the parties, on the basis of findings regarding these five "test" cases or properties. The properties selected by the parties are representative and are intended to obviate the need for further litigation concerning each property owned by the eight partnerships.

The five "test" partnerships and properties are as follows:

Name and Address of Property	Partnership Name
Bank of Florida Building 2350 34th St. North St. Petersburg, Florida	Seaside Properties Co.
Duluth Post Office 2800 W. Michigan St. Duluth, Minnesota	Duluth Properties Co.
Hacienda Bank Building 11900 Brookhurst St. Garden Grove, California	Oxnard Properties Co.
First Valley Bank Building One Bethlehem Plaza Bethlehem, Pennsylvania	Bethlehem Properties Co.
Progressive Savings and Loan Building 12175 Ventura Blvd. Studio City, California	Progressive Properties Co.

Petitioner, Sol Finkelman, resided in California when the petition was filed in this case. His tax return for 1975 was filed jointly with his "then" wife, Helen. His tax returns for the years 1976-1982 were filed jointly with his "then" wife, Luisa. The stipulated facts and exhibits are incorporated herein by this reference.

Petitioner was born in Warsaw, Poland, in 1918 and immigrated to the United States in 1923. During military service in the United States Army, petitioner was responsible for various financial and accounting functions. In 1947, petitioner received his Bachelor's degree in Business Administration with a specialization in accounting from the City College of New York. In 1949, he became a certified public accountant in the State of New York and,

in 1951, was certified in California. After graduating from college, he worked as an accountant, initially in New York and then in California. In June 1956, petitioner opened his own office, representing clients in financial and business matters, including real estate transactions, estate planning, pension matters, investment planning, accounting and tax matters. He has engaged in investment counseling as part of his accounting practice since 1948.

Petitioner typically proposed investments in real estate to his clients. Commercial property under a long-term lease to a single tenant was normally recommended. During the years 1947 to 1970, petitioner, on numerous occasions, advised clients concerning specific real estate transactions.

Background – Penner Transactions

Sometime in 1969, petitioner began to look for and buy commercial real estate for his own account and for clients who were interested in real estate investment. During 1969, petitioner, on behalf of several of his clients, purchased two post offices from Selden Ring (Ring), a real estate developer. Several months later, petitioner contacted Ring about the purchase of additional commercial properties and was referred to Ring's partner, Joseph Penner (Penner).

Penner, a real estate builder and developer, had engaged in real estate investment since 1962. His activities included the construction, development, acquisition, management and sale of real estate throughout the United States. Penner purchased and/or constructed

numerous post office buildings for the United States Government. Penner also built and owned commercial buildings leased to single "major credit" tenants. Penner's business, up until 1970, involved the occasional sale of real properties.

Beginning approximately in 1970, the Penner Ring Co. (a partnership in which Penner was involved) and thereafter Penner individually, began to sell[3] real estate to partnerships formed by petitioner, or to petitioner on behalf of partnerships. From 1970 to 1982, petitioner or said partnerships purchased approximately 50 properties from Penner. The first two properties (post offices located in California and Montana) were acquired in 1970 by the Orange/Wolf Point Properties partnership. The vast majority of the properties Penner sold were to petitioner or to entities controlled by petitioner. From 1970 to 1975, the properties purchased were all post offices. In 1975, petitioner purchased ten properties from Penner, one of which was the Pacific Telephone Building in Concord, California. This was the first "Penner property" that was not a post office.

After 1975, petitioner shifted focus from post offices to commercial buildings with long-term net or master leases. This was done because the maintenance costs and obligations of a lessor under a standard post office lease had increased considerably as a result of inflation and other factors, and Penner was reluctant to enter into the kind of maintenance contracts for future post office deals

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[3] The terms "sell," "sale," "purchase" and the like are used for convenience, and do not imply that a sale occurred for Federal income tax purposes.

that had been negotiated in prior transactions.[4] During the period at issue, rents for the type of properties petitioner acquired could be expected to rise between three and four percent annually.

Generally, negotiations for the purchase and sale of properties owned by Penner to petitioner or the partnerships would commence late in the year preceding the year of sale or early in the year of sale. At the beginning of the negotiation process, information would normally be furnished by Penner to petitioner. The information concerned the land, improvements, tenant, applicable lease terms including the rental, underlying indebtedness, and Penner's desired purchase terms. The purchase terms included the amount of the down payment, amount of any balloon payments, and the length of the payout period. After the initial exchange of information and terms, Penner and petitioner would negotiate the final terms of sale. The negotiations would focus on price, interest rate, seller financing, down payment, financing period and amount of balloon payments.

In some of the transactions, instead of a purchase of the fee, the improvements were purchased and a ground lease was executed. In such transactions, the improvements would revert to Penner at the end of the ground lease. In two out of three instances, for the test properties,

[4] When a post office was involved, petitioner generally attempted to negotiate a maintenance contract with Penner as part of the terms in order to place a ceiling on anticipated maintenance costs.

there was some documentation indicating that the partnerships had the option to purchase the underlying property at or near the termination of the ground lease. This documentation included an option agreement with "November ___, 1980" as the date (Progressive) and a letter written 3 years after the date of sale (Bank of Florida).

Penner would typically ask for a price based on an all cash deal. Petitioner would then submit a "below-market financing proposal" back to Penner with an increased purchase price.

The down payment, in a typical real estate transaction between Penner and Finkelman (or a partnership),[5] was paid out over 2 or 3 calendar years. The transaction was structured so that after the down payment was fully paid, the cash flow from the rental payments under the existing lease on the property would be paid by the tenant either to an independent corporate trustee or to Penner directly. It was credited to the unpaid interest and principal on the promissory notes, as well as to any ground rents due Penner on properties where the partnership had only a ground lease. Ten to fifteen years after the purchase agreement was executed, a substantial balloon payment, equal to two to four times the original down payments, would be due to Penner. The balance remaining after the balloon payments was due usually at or about the time the initial term of the underlying lease ended.

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[5] Hereinafter, unless otherwise noted, references to petitioner in the transactions also refer to the partnership for which he was purportedly acting.

The interest on the unpaid balance of the purchase price was structured in two tiers – it would run for an initial fixed term (usually the first 36 months) at or slightly below market rates and for the remaining period at rates significantly below market.

Once the terms were agreed to, the necessary documentation was prepared for review and execution by Penner's attorney in California. The documentation typically included an agreement of sale, one or more promissory notes. deeds of trust or mortgages, assignment of lease, collateral assignment of lease, financing statements, ancillary letter agreements, and deed. The documents were typically executed at the end of the year or later, but were made effective many months earlier.

From 1977 through 1981, partnerships formed by petitioner purchased properties from Penner. The partner-investors were primarily petitioner's clients or former clients or people referred to petitioner by other professionals. Petitioner characterized the partnerships as "Tax Oriented Ventures." In most cases, the partnership formed to purchase the property would be a party to the documentation confirming the particular purchase. In 1979, however, the documentation appears in petitioner's name only.

When a property was offered for sale to petitioner, he would review the data available and determine if he or one of his partnerships was interested in purchasing the property. Petitioner declined to purchase at least 22 properties offered for sale by Penner. Petitioner did not necessarily inspect the properties that he purchased. One of the properties involved in this case, the Duluth Post Office,

was turned down twice before petitioner agreed to purchase it.

In certain transactions, including the First Valley Bank and Progressive Savings and Loan transactions, Penner retained a right to refinance the underlying indebtedness subject to certain limitations, terms and restrictions. If the underlying financing was obtained when interest rates were relatively high, Penner required the ability to refinance on more favorable terms when economic conditions changed.

Of approximately 50 properties purchased from Penner between 1978 and 1981, only three of the properties have had balloon payments come due or have been sold. Of these three properties, one was sold before the balloon payment due date; one had the balloon payment come due and it was paid; and the third had the balloon payment come due and it was not paid.

Penner and his associates were not partners in any of petitioner's partnerships. Petitioner was not aware of the manner by which Penner treated the transactions for income tax purposes.

Petitioner received a partnership interest in each real estate partnership formed by him in exchange for his services. This interest consisted of a percentage of profits and losses, as well as a capital interest subject only to the right of other partners to first recover their cash contributions.

Duluth Post Office

In 1977, Duluth Properties Co., a California partnership, purchased an undivided one-half interest in a fee

estate located in Duluth, Minnesota, from Solar Properties Co. The property consists of land and improvements which, at the time of purchase, were leased to the United States Postal Service for use as the United States Post Office facility at 2800 West Michigan Street in Duluth, Minnesota.

Duluth is a major inland port for Great Lakes shipping. Located adjacent to Duluth is the city of Superior, Wisconsin. The Duluth Post Office is centrally located in the Duluth-Superior area near the intersection of major highways. Access ramps connecting the area to Interstate 35 are at 27th Avenue West, less than one block from the subject property.

The Duluth Post Office consists of a main building, a vehicle maintenance facility and miscellaneous improvements. The improvements, constructed in 1969, were in very good condition and were used for the Duluth main post office and for the Management Sectional Center, an operating hub for administrative and carrier functions. The subject property is zoned for a wide range of commercial and industrial uses.

By deed dated July 19, 1968, the United States conveyed the land to Penner-Ring Co., a partnership consisting of Joseph Penner, Selden Ring and Ellis Ring. The conveyance was subject to the condition that the partnership construct a postal facility on the property and thereafter lease the facility back to the United States. The Penner-Ring partnership caused the construction of the improvements in 1969 and 1970.

The initial term of the lease between Penner-Ring Co. and the United States (lease) is from March 1, 1970 to

February 28, 2000 a period of 30 years. The annual rent during the initial term of the lease is $218,400 payable $18,200 per month at the end of each month. The lessee is granted eight consecutive 5-year renewal options with annual rental during the renewal period totaling $225,000 per year. The lease is a net lease, with the lessee assuming obligations for utilities, taxes and some (but not all) repairs and maintenance on the leasehold. Under the terms of the lease, the lessee is granted options to purchase the Duluth Post Office property at the end of the initial 30-year term and at the end of each of the first four renewal periods at a price of $4,400,000, and at the end of the second four renewal periods at a price of $4,200,000.

In 1971, Joseph Penner and Selden and Ellis Ring became tenants in common by agreement dated June 14, 1971, with Penner acquiring a 50-percent interest and the Rings acquiring a 50-percent interest. By Agreement of Sale dated December 21, 1977, Joseph and Grace Penner (Penners) agreed to sell all their right, title and interest in and to the Duluth Post Office property and the Tenancy in Common Agreement (TIC Agreement), and to assign all their rights and obligations in the lease to Solar Properties Co. (Solar), a limited partnership owned by petitioner and his son, Lawrence. The purchase price for the 50-percent interest was $1,548,231, payable as follows: (1) a cash payment of $85,667 at closing; (2) a nonrecourse promissory note (Purchase Note) for $228,827; and (3) acquisition of the property subject to the exiting senior indebtedness[6] (Senior Note), 50 percent of which equaled

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[6] The Senior Note was in the face amount of $2,670,000 and payable to the First Bank of Boston. The remaining balance at the time of purchase was $2,465,474.28.

$1,232,737.14. By letter dated December 21, 1977, the terms of the sale agreement were modified to permit the initial cash payment to be made in two parts – $73,000 in December 1977 and $13,677 on January 5, 1978.

The Penners' undivided one-half interest in the Duluth Post Office property was conveyed to Solar by warranty deed dated December 21, 1977. In addition, an Assignment of Lease and Acceptance of Assignment, as well as an Assignment of the TIC agreement, were executed by the parties and along with the deed were duly recorded in the land records.

The Purchase Note was in the principal amount of $228,827 and bore interest at the rate of 10 percent from April 1, 1977. A principal payment of $173,333, guaranteed by petitioner, was due March 31, 1978, and the remaining principal and interest was due on February 28, 2000. The Purchase Note was secured by a Purchase Mortgage, a Collateral Assignment of Lease, and by a financing Statement on the fixtures and personal property, each of which was duly recorded in the land records. The Postmaster General was notified of the transfer of one-half of the property ownership of Solar.

Solar entered into a contract with Duluth Properties Co. (Duluth), a California limited partnership, to sell the one-half interest it had just acquired in the Duluth Post Office property. The Agreement of Sale was dated December 22, 1977. Solar was used as an intermediary in this transfer from the Penners to Duluth because of the potential adverse tax consequences to the Penners from a direct transfer. The conveyance from Solar to Duluth was authorized in writing by the Penners, who agreed that the

conveyance would not accelerate the principal and interest on the Purchase Note.

The purchase price in the Duluth-Solar transaction was $2,301,000, payable as follows: (1) $85,000 cash at closing; (2) a wraparound nonrecourse promissory note in the amount of $2,301,000.[7] Under the terms of the agreement, an additional payment in the amount of $175,000 was due on March 31, 1978. These terms were the same as those in the original proposed direct sale between Penner and Duluth.

Under the terms of the wraparound promissory note, Duluth promised to pay Solar $2,301,000 on or before July 31, 2004, with interest at the rate of 10 percent per annum for the first 36 months and 5 percent per annum thereafter. The promissory note was secured by a mortgage dated December 23, 1977, which was duly recorded. The conveyance was accomplished by a warranty deed dated December 23, 1977.

The parties also executed an Assignment of Lease, an Assignment of the TIC Agreement, a Collateral Assignment of Lease, a Security Agreement, and a Financing Statement. In addition, in the Maintenance Agreement, Solar assumed the administrative obligations of Duluth as Lessor, agreed to maintain insurance on the property, and agreed to perform all repairs and maintenance on the property in accordance with its terms. The Postmaster General was notified of this transfer.

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[7] Apparently, the $85,000 cash was part of and was to be applied to the $2,301,000 note, although this is not clear in the record.

A $2,301,000 title insurance policy was issued to Duluth in February 1978 and a certificate of title was issued to Duluth.

By letter dated March 20, 1978, the investors in Duluth were advised that the partnership had acquired the post office property and were furnished with a balance sheet and statement of income and expenses for the 9 months ended December 31, 1977. Duluth filed partnership tax returns for each of the calendar years 1977 through 1982 in which it reported its one-half share of the gross rental income, as well as deductions for depreciation, interest, maintenance, and miscellaneous expenses as follows:

	1977	1978	1979	1980	1981	1982
Rental Income	81,900	109,200	109,200	109,200	109,200	109,200
Expenses:	–	–	–	–	–	–
Depreciation	(101,665)	(135,553)	(135,553)	(135,553)	(135,553)	(131,438)
Interest	(175,718)	(223,452)	(230,913)	(150,271)	(121,374)	(122,119)
Maintenance	(1,800)	(2,400)	(2,400)	(2,400)	(2,400)	(2,400)
Other	(62,400)	(33,500)	–	–	–	–
Net Loss	(259,683)	(285,705)	(259,666)	(179,024)	(150,127)	(146,757)

The partnership was on the accrual method of accounting.

Petitioner maintains the books and records and is the managing partner of Duluth. The initial capital of Duluth consisted of capital contributions from the various investors totaling $442,500, of which $185,000 was received in 1977 and $257,500 in 1978. Of the capital contributed, $260,000 was paid to Solar under the Agreement of Sale, the $85,000 initial payment and the $175,000 payment due in March 1978.

The investors in Duluth, their percentage interest and capital contributions were as follows:

Name	Percentage	Contribution
Sol Finkelman	4.00	–
Lawrence Finkelman	1.00	–
Bergstrom	12.80	$ 60,000
Biagotti	6.44	30,000
Carmichael	6.44	30,000
Crnkovitch	16.11	75,000
Dana	9.66	45,000
Dicus	6.44	30,000
Floum	12.88	60,000
Larson	9.66	45,000
Roubal	9.66	45,000
Votava	4.83	22,500
Total	100.00[8]	$442,500

No part of the initial capital contributed by investors was allocated to the capital accounts of petitioner or his son on the partnership returns.

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[8] Due to rounding error, the column only totals to 99.92 percent.

Solar realized a gain on the sale of the post office property to Duluth. The sale was reported on the installment basis on its partnership returns for 1977 and 1978 and a percentage of gain from the sale was included in income each year. Solar also took a deduction for interest expense paid to Joseph Penner.

In April 1977, corporate bonds rated AAA yielded 8.04 percent. Corporate bonds with an A rating yielded 8.55 percent.

Hacienda Bank

In 1977, Hacienda properties Co. (Hacienda or partnership), a California limited partnership formed by petitioner,[9] entered into an agreement to purchase an interest in property located in Garden Grove, California, at 11900 Brookhurst Street. It is improved by a one-story bank building and related improvements which, on the date of purchase, were leased and occupied by Hacienda Bank. The improvements were completed in 1974 and are in excellent condition.

Garden Grove is located in Orange County, California, approximately 27 miles southeast of the Los Angeles Civic Center and approximately 8 miles northwest of Santa Ann. Garden Grove is connected by freeways to all parts of Los Angeles and Orange Counties. The subject property is a 1.33 acre parcel that has access to Brookhurst Street and Chapman Avenue in Garden Grove. The neighborhood is fully developed primarily

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[9] Apparently, Hacienda was later merged into and renamed Oxnard Properties Co. (Oxnard).

with shopping centers, strip commercial, service stations and fast food restaurants. A part of the neighborhood, but not the bank property, is within the boundaries of a redevelopment area and has received financial assistance from the city's redevelopment agency for public improvements and architectural services such as landscaping and sign control. The property is zoned to permit a wide range of commercial uses including retail stores, hotels, service stations and business and professional offices.

By deed dated April 23, 1973, the Home Savings and Loan Association conveyed the subject land to Hacienda Bank for a reported sales price of $300,000 cash. Thereafter, Hacienda Bank contracted for the construction of the improvements, which were completed in May 1974. In November 1974, Hacienda Bank conveyed the land and improvements to Joseph and Grace Penner for a reported sales price of $600,000 cash.

By a lease dated November 15, 1974, the Penners leased back the land and improvements to Hacienda Bank for a 30-year period commencing November 15, 1974, and terminating on November 14, 2004. The rent under the lease agreement is $66,000 per year payable $5,500 per month in advance on the first day of each month. The lease is a triple net lease. Maintenance, repairs, taxes, utilities and other charges are the sole responsibility of the lessee as additional rental. If the lessee is not in default, it has the option to renew the lease for an additional term of 10 years. The rental for the option term is set by mutual agreement or, failing agreement, according to "prevailing rental rates" in the area, not to fall below $66,000 triple net rent.

On December 23, 1977, the Penners agreed to sell the improvements on the subject property, assign the existing lease and lease the land (ground lease) to Hacienda for a purchase price of $1,161,900. The purchase price was paid with two nonrecourse promissory notes secured by deeds of trust and assignments of rent. The first was a wrap-around note (Purchase Note) in the face amount of $1,061,900, bearing interest at the rate of 10 percent per year for the first 3 years and 5 percent thereafter. Monthly payments of $4,200, to be applied first to interest and then to principal, were due commencing May 1, 1977 until November 1, 2004. In addition, principal payments of $35,000 and $90,000 were due on December 31, 1977, and March 31, 1978, respectively. These initial principal payments were approximately 11 percent of the purchase price. Payments of interest were also required in the amounts of $200,000, $100,000 and $100,000, due on March 1, 1993, December 1, 1993, and June 1, 1995, respectively. Any unpaid balance is due November 14, 2004. The Purchase Note is subordinate to and wraps around a promissory note (Senior Note) dated August 2, 1976, in the face amount of $535,000 in favor of Mortgage Investment Securities, Inc., secured by a deed of trust and assignment of rents.

The second note, in the face amount of $100,000 and bearing 10- percent interest, is due May 1, 1997. Monthly payments of interest of $800 per month are due under the note. Under the ground lease, Hacienda agreed to pay $6,000 per year, payable $500 per month, for the period from May 1, 1977 through November 14, 2004.

The partnership did not receive any of the rental payments under the lease. Rather, they were applied

monthly towards the purchase obligations, as follows: (1) $500 – ground lease; (2) $4,200 – Purchase Note; and (3) $800 – second note. The Penners were obligated to make the payments on the underlying Senior Note.

In May of 1978, the deed was duly recorded and a policy of title insurance was issued to Hacienda Properties Co. and Joseph and Grace Penner.

Oxnard Properties (successor to Hacienda) filed partnership tax returns for each of the years 1977 through 1982 in which it reported gross rental income and depreciation, interest, and miscellaneous expenses as follows:

	1977	1978	1979	1980	1981	1982
Rental Income	44,000	66,000	66,000	66,000	66,000	66,000
Expenses:	–	–	–	–	–	–
Depreciation	(45,417)	(68,126)	(68,126)	(68,126)	(68,126)	(68,126)
Interest	(78,563)	(112,212)	(115,232)	(83,183)	(65,516)	(65,841)
Ground Rent	(4,000)	(6,000)	(6,000)	(6,000)	(6,000)	(6,000)
Other	(22,050)	(8,000)	–	–	–	–
Net Loss	(106,030)	(128,338)	(123,358)	(91,309)	(73,642)	(73,967)

The partnership was on the accrual method of accounting.

Petitioner maintains the books and records and is the managing partner of Oxnard. The initial capital of Oxnard consisted of capital contributions from various investors totaling $390,000, of which $145,000 was received in 1977 and $245,000 in 1978. The investors in Oxnard, their percentage interests and their capital contributions were as follows:

Name	Percentage	Contribution
Sol Finkelman	4.00	–
Lawrence Finkelman	1.00	–
Ameli	7.31	$ 30,000
Carter	3.65	15,000
Duff	21.93	90,000
Meyer	3.65	15,000
Noble	7.31	30,000
Pardasani	7.31	30,000
Poral	3.65	15,000
Rohde	3.65	15,000
Somerville	25.58	105,000
Tesoro	10.96	45,000
Total	100.00	$390,000

No part of the initial capital contributed by the investors was allocated to the capital accounts of petitioner or his son. The average interest rate for mortgages on commercial service property during the second quarter of 1977 was 9.55 percent.

Bank of Florida

In 1977, Seaside Properties Co. (Seaside), a California partnership formed by petitioner, purchased an interest

in certain real estate located at 2350 34th Street N. in the city of St. Petersburg, Penellas County, Florida. It consists of two parcels totaling 2.45 acres. Parcel number 1 is improved by a two-story bank building and by parking lots. Parcel number 2 is improved by a drive-through banking facility. At the time of purchase, the land and improvements were leased to the Bank of Florida Corporation for use as a banking facility by the Bank of Florida.

The first parcel and part of the second are zoned C-LD (Commercial, Low Density). The balance of the second parcel is zoned R-3 (Multifamily Residence). The St. Petersburg Land Use Plan designates the entirety of both parcels as "retail/office service."

On September 7, 1976, the Penners entered into a lease with the Bank of Florida Corporation with respect to the St. Petersburg property. The initial term of the lease was for 29 years, commencing upon substantial completion of improvements and upon issuance of the temporary certificate of occupancy. The Penners had agreed to construct the improvements in accordance with the terms of a sale and leaseback agreement with the Bank of Florida. The improvements were completed in 1977. They are competitive with, and physically and functionally similar to, other contemporary banking facilities in the St. Petersburg area.

The annual base rental required by the lease was $59,000 plus an amount equal to the cost of the real property to the Penners ($350,000) and all direct and indirect costs of construction and other costs exceeding $550,000 times .1075, payable monthly in advance. The monthly rental paid by the Bank of Florida under the

lease during 1977 and thereafter was $10,629.34. The lease is a triple net lease. If the lessee is not in default, it has the option to renew the lease for two terms of 11 years each. The rental during the option periods is a mutually agreed upon amount, or, failing agreement, the "prevailing rental rate" for commercial property in St. Petersburg, not to fall below the base rental.

In June 1977, the Penners took a mortgaged loan (Senior Note) in the original amount of $980,000 in favor of Mortgage Investment Securities, Inc. The note bears interest at the rate of 9-3/8 percent and requires monthly payments of $8,151.15 commencing August 1, 1977, and ending June 1, 2002, with any unpaid balance also due on that date. The mortgage and an assignment of rents secures the indebtedness.[10]

By agreement of purchase and sale dated December 23, 1977, the Penners sold the improvements, assigned the lease, and leased the land (ground lease) to Seaside for a price of $2,259,900. The price was paid by a wrap-around nonrecourse promissory note (Purchase Note), executed April 5, 1978, secured by a mortgage and collateral assignment of lease. The Purchase Note requires monthly payments in the amount of $9,629.34 commencing on June 1, 1977, and continuing through May 1, 2006. The payments are applied first to interest and then to principal. The note bears interest for the first 3 years at 10 percent and at 5 percent thereafter. Payments of principal were required in the amounts of $71,000 and $170,000 on

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[10] The mortgage was subsequently assigned to First Federal Savings and Loan of Wilmette.

December 31, 1977, and March 31, 1978, respectively. These payments represented approximately 10.6 percent of the purchase price. Additional payments of interest in the amounts of $400,000, $200,000 and $200,000 are due March 1, 1993, December 1, 1993 and June 1, 1995, respectively. Any balance remaining was due May 31, 2006. The Purchase Note is subordinate to and "wraps around" the $980,000 Senior Note.

Seaside did not receive any of the rental payments. Rather, the $10,629.34 monthly rental was applied as follows: (1) Ground lease – $1,000; and (2) Purchase Note – $9,629.34. The Penners are obligated to make the payments on the Senior Note. The deed to the improvements was not recorded.

By letter dated March 20, 1978, the investors were advised that Seaside had acquired an interest in the Bank of Florida property and were furnished with a balance sheet and statement of income and expenses for the period ended December 31, 1977. Seaside filed partnership tax returns for the years 1977 through 1982 in which it reported gross rental income as well as deductions for depreciation, interest and other expenses, as follows:

	1977	1978	1979	1980	1981	1982
Rental Income	74,406	127,552	127,552	127,552	127,552	127,552
Expenses:	–	–	–	–	–	–
Depreciation	(75,769)	(129,889)	(129,889)	(129,889)	(129,889)	(129,889)
Interest	(133,461)	(217,494)	(223,551)	(164,773)	(117,244)	(117,331)
Maintenance	(7,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)
Other	(59,000)	(30,000)				
Net Loss	(200,824)	(261,831)	(237,888)	(179,110)	(131,581)	(131,668)

The partnership was on the accrual method of accounting.

Petitioner maintains the books and records and is the managing partner of Seaside. The initial capital of Seaside consisted of capital contributions from various investors totaling $330,000, $133,000 received in 1977 and $197,000 in 1978. The initial investors in Seaside, their percentage interests and capital contributions as shown on the 1977 return were as follows:

Name	Percentage	Contribution
Sol Finkelman	4.00	–
Lawrence Finkelman	1.00	–
Sol Finkelman	10.80	$ 37,500
Baxter	6.47	22,500
Cabral	4.32	15,000
H. Finkelman	4.32	15,000
Funk	4.32	15,000
Goldman	4.32	15,000
Larson	4.32	15,000
Lawson	4.32	15,000
Pathak	4.32	15,000
Pirachi	4.32	15,000
Prince	6.47	22,500
Reiswig	8.63	30,000
Scofield	4.32	15,000
Shah	4.32	15,000
Stahle	2.16	7,500
Thomas	4.32	15,000
Wintner	8.63	30,000
Zahir	4.32	15,000
Total	100.00	$330,000

In 1978, two additional partners were added. The partnership percentages set forth above remained the same with the exception of the following:

S. Finkelman 2.16
Klein 4.32
Rasinski 4.32

First Valley Bank

In 1979, petitioner entered into an installment sale agreement to purchase certain property located in Bethlehem, Pennsylvania. The property is located at One Bethlehem Plaza. It is improved by an eleven-story building, vehicle loading area and miscellaneous improvements. At the time of purchase, the property was leased to First Valley Bank for use as a banking facility and office building. The improvements were constructed in 1974 by First Valley Properties, Inc. and are in excellent condition.

By lease agreement dated November 14, 1978, First Valley Properties, Inc., a Pennsylvania business corporation of which Joseph and Grace Penner were the sole shareholders, leased the land and improvements to First Valley Bank, a Pennsylvania banking institution. The initial term of the lease is for a period of 22 years beginning November 14, 1978, and ending November 13, 2000. The annual rent during the initial term of the lease is $830,000 per year for the first 11 years and $850,000 per year thereafter. Rent is payable $69,166.67 in advance each month during the first 11 years, and $70,833.33 in advance per month thereafter. The lease is a triple net lease. The lessee has the option to renew for four option periods, the first of 8 years and the subsequent three for 10 years each. The annual rent during each of the extension periods is $870,000 ($72,500 per month), $890,000 ($74,166.67 per month), $910,000 ($75,833.33 per month)

and $930,000 ($77,500 per month), respectively. The lease was assigned to the Penners in a liquidating distribution of First Valley Properties on November 14, 1978.

By installment sale agreement made as of October 12, 1979, the Penners contracted to sell the land and improvements to petitioner. The agreement was subsequently amended by the parties and confirmed by an undated letter from Penner which was acknowledged on April 30, 1983, by petitioner. A memorandum of installment sale agreement dated February 25, 1985, was subsequently recorded.

At the time the installment sales agreement was entered into, the property was subject to two notes in favor of Continental Illinois Bank and Trust Company of Chicago in the aggregate principal sum of $8,000,000 which were secured by two mortgages, a security agreement and a financing statement on the premises. One note was in the principal amount of $6,500,000 and the other note represented the remainder. The notes were due on or before May 13, 1979.

The sale agreement provided that the seller had the right to refinance the property by paying off the aforementioned notes and securing financing at the seller's sole cost and expense. The replacement notes would be secured by a first mortgage and related documents and would constitute the first lien on the property. In no event could the original amount of the replacement note exceed $9,000,000, and in no event could the monthly debt service exceed the monthly rent payable by First Valley Bank during the first 11 years of the lease term.

The purchase price of the property was $12,500,000, $12,300,000 specified in the installment sale agreement and $200,000 in a junior note. The $12,300,000 amount bears interest at 11 percent per year for 3 years and 6-1/2 percent thereafter. The average interest rate for mortgages on office buildings during the fourth quarter of 1978 was 9.81 percent. Monthly payments were required under the installment sale agreement as follows:

Period	Monthly Payment
1/1/79-7/1/79	$69,166.67
8/1/79-1/1/80	90,529.00
2/1/80-4/1/80	86,503.00
5/1/80-1/1/81	82,431.00
2/1/81-4/1/81	75,754.00
5/1/82-12/1/89	69,166.67
1/1/90-11/1/2000	70,833.33

The agreement was apparently orally amended so that the monthly payments did not exceed the rent paid by the lessee ($69,166.67).[11] Each monthly payment was to be applied first to interest and then to principal. Any unpaid balance was due on December 1, 2000. Additional payments were required as follows: (1) $483,000 due December 31, 1979; (2) $488,750 due March 31, 1980; (3) $671,625 due December 31, 1980; and (4) $791,625 due March 31, 1981. These payments represented 19.4 percent of the total purchase price. Also, payments of $975,000 are due on September 30, 1992, and September 30, 1993.

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[11] There is no writing memorializing this amendment, however, apparently no payments were made in excess of the monthly rental amounts.

The $200,000 note bears interest at the rate of 11 percent and is due January 1, 2004.[12]

The lease was used as security under the agreement. Petitioner does not receive the rents under the lease. Rather, they are paid directly to the Penners as the required payments under the sale agreement.

Petitioner had the right of possession and control of the premises subject to the lease and subleases upon execution of the sale agreement. The Penners are obligated to make the required payments on the underlying indebtedness and any replacement (refinancing) indebtedness.

By letter dated October 12, 1979, the Penners authorized a transfer of the property so long as petitioner continued to control it. Bethlehem Properties Co. is a joint venture formed as of January 1, 1979, to acquire, develop, lease, operate and sell the First Valley Bank property. Petitioner is the managing general partner.

Bethlehem Properties Co. filed partnership tax returns for each of the calendar years 1979 through 1982 in which it reported gross rental income as well as deductions for depreciation, interest and miscellaneous expenses with respect to First Valley Bank property as follows:

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[12] This note was later purchased at a discount by petitioner.

	1979	1980	1981	1982
Rental Income	830,000	830,000	830,000	830,000
Expenses:	–	–	–	–
Depreciation	(1,455,073)	(1,455,073)	(1,455,073)	(1,070,129)
Interest	(1,461,049)	(1,395,954)	(1,294,922)	(779,345)
Administration	(79,000)	(39,750)	–	–
Organization	(28,500)	(28,500)	(28,500)	(28,500)
Legal/Accounting	(158,500)	(79,000)	–	–
Net Loss	(2,352,122)	(2,168,277)	(1,948,495)	(1,047,974)

The partnership was on the accrual method of accounting.

Petitioner maintains the books and records and is the managing partner of Bethlehem. The initial capital of Bethlehem consisted of capital contributions from various investors totaling $2,850,000, of which $768,725 was contributed in 1979, $1,463,775 in 1980, and $617,500 in 1981. The investors in Bethlehem, their percentage interests and their capital contributions are reflected in the partnership tax returns.

No part of the initial capital contributed by the investors was allocated to the capital accounts of Sol or Lawrence Finkelman.

By letter dated April 16, 1980, a balance sheet and statement of income and expense for the period ended December 31, 1979, was forwarded to the investors together with a copy of the joint venture agreement and a signature page which each investor was asked to sign and return.

Progressive Savings and Loan

In 1980, petitioner entered into an agreement to purchase an interest in property located in Studio City, California. The property in question is improved by a two-story bank building and related improvements which, on the date of purchase, were leased to and occupied by Progressive Savings and Loan Association (Progressive). The property is located at 12175 Ventura Boulevard, Studio City, California. Studio City is a community located in the San Fernando Valley area of Southern California and

is a part of the city of Los Angeles. The improvements were extensively remodeled in 1977 and were in excellent condition.

On June 9, 1977, JSCK Corporation deeded the property to Progressive. Progressive subsequently remodeled the improvements and then deeded the property to the Penners on March 5, 1979, for a reported consideration of $1,200,000. Progressive leased the property back from the Penners.

The initial term of the lease was for 30 years, commencing on March 14, 1979, and terminating on March 14, 2009. Under the terms of the lease, Progressive is obligated to pay rentals of $9,250 per month for the first 15 years of the lease, and $9,500 per month thereafter.[13] The lease is a triple net lease. Progressive has the option to renew the lease for an additional 20 years. The monthly rental during the option period is equal to 9-3/8 percent of the fair market value of the property as of the last day of the 30-year term, but the rent cannot fall below $9,500 and cannot exceed $9,500 compounded at 3 percent for 30 years. If the parties cannot agree, the lease provides a procedure for determining fair market value.

By agreement of purchase and sale dated November 26, 1980, the Penners agreed to sell the improvements on the subject property, to assign their interest in the lease and to lease the land (ground lease) to petitioner. The purchase price was $1,690,000, paid with two promissory

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[13] Rent for the first and last partial calendar months is prorated.

notes. The first (Purchase Note) was a wraparound promissory note in the face amount of $1,642,500 dated November 26, 1980. The second was a junior note in the face amount of $47,500. Both notes are nonrecourse and secured by deeds of trust and collateral assignments of lease.

Under the terms of the Purchase Note, petitioner is obligated to pay the Penners $6,918 per month commencing January 1, 1980 until December 1, 1994, and $7,168 per month from January 1, 1995, until maturity. The monthly payments are applied first to interest and then to principal. The note bears interest at the rate of 15 percent per year for the first 3 years and 6 percent per year thereafter. The average interest rate for mortgages on commercial service property during the fourth quarter of 1979 was 10.82 percent. In addition to the monthly payments, payments of principal were required as follows: (1) $79,000 due December 31, 1980; (2) $90,000 due March 31, 1981; (3) $85,000 due December 31, 1981; and (4) $103,000 due March 31, 1982. These payments represented 21 percent of the purchase price. Also, payments of $370,000 and $315,000 were due on June 30, 1995, and October 1, 1995, respectively. The unpaid balance is due December 31, 1999. Petitioner, by letter agreement, was granted the right to prepay the note at a discount between January 1 and March 31, 1995.

The Purchase Note is subordinate to and wraps around two promissory notes, one dated May 21, 1980, in the amount of $686,300 in favor of Coast Federal Savings and Loan, and the second in the amount of $547,000. Both were secured by deeds of trust and assignments of rents.

The junior note, in the amount of $47,500, is due on or before December 1, 1995. It bears interest at the rate of 15 percent per year for the first 4 years and 6 percent thereafter. Monthly payments of $483.80 are required, applied first to interest and then to principal.[14]

The monthly rent under the ground lease for the period January 1, 1980 to December 31, 1999, was $1,848. The deeds of trust and assignments of rent were duly recorded in the land records.

Petitioner did not receive any of the monthly rentals from Progressive. The $9,250 monthly rental was applied as follows: (1) $1,848 – ground lease; (2) $6,918 – Purchase Note; and (3) $484 – junior note. The Penners are required to make the payments on the underlying indebtedness.

Progressive Properties Co. is a joint venture formed as of January 1, 1980, to acquire, develop, lease, operate and sell the Studio City property and other properties. Petitioner is the managing general partner of the joint venture.

Progressive Properties Co. filed partnership tax returns for each of the calendar years 1980 through 1982 in which it reported gross rental income as well as deductions for depreciation, interest and miscellaneous expenses with respect to the Studio City property as follows:

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[14] The Penners were granted an option to require petitioner to purchase this note from them at a discount until Nov. 26, 1981.

	1980	1981	1982
Rental Income	111,000	111,000	111,000
Expenses:	–	–	–
Depreciation	(133,655)	(133,655)	(133,655)
Interest	(272,943)	(279,194)	(280,127)
Ground Rent	(22,176)	(22,176)	(22,176)
Legal/Accounting ...	(43,978)	(15,018)	–
Administrative	(21,999)	(7,502)	–
Organization	(5,765)	(3,937)	(3,937)
Net Loss	(389,516)	(350,482)	(328,895)

The partnership was on the accrual method of accounting.

Petitioner maintains the books and records and is the managing partner of Progressive Properties Co. The initial capital contribution of Progressive Properties Co. consisted of capital contributions from various investors totaling $2,910,000, of which $737,200 was contributed in 1980, $1,552,000 in 1981 and $620,800 in 1982. By letter dated April 1, 1981, the investors were furnished a balance sheet and statement of income and expenses for the period ending December 31, 1980, together with a copy of the joint venture agreement and a signature page that each investor was asked to sign and return.

Valuation

Each of the parties offered expert opinions regarding the fair market value of the properties. We find the fair market values of the test properties, at the time purportedly acquired by petitioner or his partnerships, to be as follows:

Duluth Post Office	$1,338,855
Hacienda Bank	740,677
Bank of Florida	1,397,897
First Valley Bank	9,010,991
Progressive Savings and Loan	980,025

OPINION

The major issue in this case concerns the tax consequences of leveraged real estate transactions; more specifically, whether the transactions must be disregarded for Federal tax purposes because they lacked economic substance and/or were primarily engaged in for tax motivated reasons. If we determine that the transactions are not to be respected, we must consider whether any of the additions to tax are applicable.

Burden of Proof

As a preliminary matter, petitioner argues that the burden of going forward with the evidence should be on respondent because one of the notices of deficiency did not give adequate grounds upon which to prepare a case. The statutory notice language in controversy is that petitioner was "not entitled" to the partnership losses at issue, without further detail.

As a general rule, petitioner bears the burden of going forward concerning matters stated in the notice of deficiency. Welch v. Helvering, 290 U.S. 111 [12 AFTR 1456] (1933); Rule 142(a). However, in a limited number of cases an exception to the general rule may arise involving unreported illegal income. In such cases, courts have "looked behind the notice of deficiency" and removed the

presumption of correctness when the determination is arbitrary or without foundation. See Weimerskirch v. Commissioner, 596 F.2d 358 [44 AFTR2d 79-5072] (9th Cir. 1979); Pizzarello v. United States, 408 F.2d 579 [23 AFTR2d 69-1575] (2d Cir. 1969); Riland v. Commissioner, 79 TC 185 (1982). In these cases the presumption of correctness is removed and the burden of going forward shifts to respondent.

Similar considerations do not readily apply with respect to disallowed deductions. The taxpayer has (or should have) complete knowledge of items deducted on his return, and should be able to prove or support the deduction(s). The Court of Appeals for the Ninth Circuit, where appeal would lie in this case, has held that the Commissioner need not make any factual showing in support of a deficiency determination based on the disallowance of deductions. United States v. Zolla, 724 F.2d 808 [53 AFTR2d 84-652] (9th Cir. 1984); Karne v. Commissioner, 673 F.2d 1062 [49 AFTR2d 82-1223] (9th Cir. 1982), affg. 73 TC 1163 (1980). See Golsen v. Commissioner, 54 TC 742 (1970), affd. 445 F.2d 985 [27 AFTR2d 71-1583] (10th Cir. 1971).

Although respondent's explanation of the disallowed loss deduction is terse, it is sufficient to apprise petitioner of respondent's determination. This is not the type of situation where respondent's determination could be considered to be no determination or to be arbitrary so that the burden of going forward with the evidence shifted to respondent. See Scar v. Commissioner, 814 F.2d 1363 [59 AFTR2d 87-950] (9th Cir. 1987), revg. 81 TC 855 (1983). Thus, the burden of going forward does not shift to respondent.

Claimed Losses - General

The central focus of this case involves losses claimed through real estate partnerships organized, directed and controlled by petitioner, Sol Finkelman. The loss deductions are composed of interest, depreciation and other administrative expenses. Respondent attacks these transactions by means of three major theories: (1) Economic substance; (2) profit objective; and (3) genuine indebtedness.

The economic reality of a transaction, rather than the form in which it is cast, governs for Federal tax purposes, Gregory v. Helvering, 293 U.S. 465 [14 AFTR 1191] (1935); Commissioner v. Court Holding Co., 324 U.S. 331 [33 AFTR 593] (1945); Grodt and McKay Realty Inc. v. Commissioner, 77 TC 1221 (1981). A transaction entered into solely to generate tax benefits, with no other economic or commercial objective to support it, is given no effect for tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 [41 AFTR2d 78-1142] (1978); Knetsch v. United States, 364 U.S. 361 [6 AFTR2d 5851] (1960). Thus, an initial inquiry is whether a sale of the subject properties occurred for tax purposes.

A related inquiry is whether the taxpayer entered into the transaction with the objective of making a profit. See secs. 162, 165, 183 and 212. We commented on this requirement in Beck v. Commissioner, 85 TC 557, 569-570 (1985), as follows:

> Essential to such a showing is a demonstration that petitioner had "an actual and honest objective of making a profit." Dreicer v. Commissioner, 78 TC 642, 646 (1982), affd. without

> opinion 702 F.2d 1205 [Unpublished order dated 2-22-83] (D.C. Cir. 1983); Fuchs v. Commissioner, 83 TC 79, 98 (1984); Dean v. Commissioner, 83 TC 56, 74 (1984). While a reasonable expectation of profit is not required, petitioner's objective of making a profit must be bona fide. Fox v. Commissioner, 80 TC 972, 1006 (1983), affd. * * * . "Profit" in this context means economic profit, independent of tax savings. Herrick v. Commissioner, [85 TC 237 (1985)]; Surloff v. Commissioner, 81 TC 210, 233 (1983).
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> Whether petitioner possessed the requisite profit objective is a question of fact to be resolved on the basis of all the facts and circumstances. Elliott v. Commissioner, 84 TC 227, 236 (1985), and cases cited therein. Although no one factor is determinative, greater weight must be given to objective facts than to petitioner's mere statement of his intent. Siegel v. Commissioner, 78 TC 659, 699 (1982); Engdahl v. Commissioner, 72 TC 659, 666 (1979); sec. 1.183-2, Income Tax Regs. * * * [Fn. ref. omitted.]

A third inquiry, similar to the economic substance question, relates to the indebtedness used to finance a transaction and involves both depreciation and interest deductions. If the purchase price and principal amount of a nonrecourse note unreasonably exceed the fair market value of the asset acquired, the note may not be considered genuine indebtedness. Under such circumstances the amount of the note will not be included in the basis of the asset and "interest" paid is not deductible. Estate of Franklin v. Commissioner, 544 F.2d 1045 [38 AFTR2d 76-6164] (9th Cir. 1976), affg. 64 TC 752 (1975); Elliott v. Commissioner, 84 TC 227 (1985), affd. without opinion

782 F.2d 1027 (3d Cir. 1986); Odend'hal v. Commissioner, 80 TC 588, 604 (1983), affd. on this issue 748 F.2d 908 [55 AFTR2d 85-319] (4th Cir. 1984).

We have used objective factors in resolving all three of these questions, even in cases involving what is normally the taxpayer's subjective intent – profit objective. See Rose v. Commissioner, 88 TC 386 (1987). In addition, with regard to each of these theories, two factors usually predominate – the relationship of purchase price to fair market value and the recourse or nonrecourse character of the debt.

Closer inspection reveals why these factors have been the central focus. One of the hallmarks of so-called "abusive tax shelters" is economic distortion occasioned by the purported transfer of ownership at grossly inflated prices. The nonrecourse "debt" assures that the "purchaser" can walk away from the transaction at any time. The inflated purchase price generally assures that the transaction cannot economically succeed, except to provide artificially bloated depreciation deductions, and investment tax credits. In general, a grossly inflated purchase price would lessen the rate of return, make resale at a profit unlikely, and make it less likely that the purchase price will be paid. "The fundamental issue in these cases generally will be whether the property has been 'acquired' at an artificially high price, having little relation to its fair market value." Estate of Franklin v. Commissioner, supra at 1046 n. 1.

Both parties rely heavily on Estate of Franklin v. Commissioner, supra, to justify their respective positions.

In that case, a limited partnership was formed to purchase a hotel and lease it back to the former owners. The purchase price was $1,224,000, financed entirely with non-recourse indebtedness. The only cash paid by the partnership was $75,000, denominated as prepaid interest. No other money was to change hands for 10 years, because payments on the purchase price were arranged to exactly equal the rental due under the lease. After 10 years, the balance of $975,000 was due, less any indebtedness of the former owners assumed by the partnership. The former owners had purchased the hotel property[15] several months before the sale for approximately $660,000.

We held that partnership losses attributable to depreciation deductions and interest expense were not allowable, because all the partnership had, in essence, was an option to purchase the property. The non-recourse character of the debt, the fact that little money changed hands, and the failure of the taxpayer to establish the value of the property were all relevant factors in finding an option. Because the optionee/partnership had no obligation to consummate the transaction, no depreciation or interest based on the "indebtedness" were allowable. Estate of Franklin v. Commissioner, 64 TC 752, 762 (1975).

The Ninth Circuit Court of Appeals affirmed, based on slightly different reasoning. While not disavowing the

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[15] They actually had purchased stock in two corporations for $800,000, one of which owned the hotel property sold. Apparently, approximately $660,000 was allocable to the property the partnership purchased.

other factors we recognized, the Court stated "the fundamental issue in these cases generally will be whether the property has been 'acquired' at an artificially high price, having little relation to its fair market value." Estate of Franklin v. Commissioner, supra at 1046 n. 1. The Court found that the transaction could not be treated as a sale, ab initio, because the purchase price exceeded a "demonstrably reasonable estimate of [the property's] fair market value."

The Ninth Circuit then went into a more detailed analysis of the specific deductions involved, depreciation and interest, and how the purchase price to market value relationship would impact such deductions. Depreciation, the Court said, is not predicated upon ownership but upon an investment in property. Estate of Franklin v. Commissioner, supra at 1049; Gladding Dry Goods Co. v. Commissioner, 2 B.T.A. 336 (1925). Payments of the purchase price must yield an equity to the purchaser, or there is no such investment in the property upon which to base depreciation deductions.

The interest deduction also received extended discussion. The absence of personal liability, the Court noted, does not deprive a debt of its character as a bona fide obligation able to support an interest deduction. Estate of Franklin v. Commissioner, supra; Mayerson v. Commissioner, 47 TC 340 (1966). However, if the purchase price and debt amount unreasonably exceed the value of the property, in the absence of personal liability there is only a "mere chance" that payment will actually occur. For debt to exist, the purchaser must confront a situation in which it is *presently* reasonable from an economic point of

view to make a capital investment in the unpaid purchase price.

The Court warned at the end of its opinion that its holding was limited, and that it did not stand for the proposition that "a sale is not a sale if the purchaser pays too much." Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 [38 AFTR2d 76-6164] (9th Cir. 1976).

Fair Market Valuation

We consider here, for the first time, a novel conceptual theory of valuation. Normally, we accept the principle that fair market value is the price that a willing seller and buyer would agree upon. Implicit in that formulation is an accepted premise that the price is based upon an exchange of cash for the asset in question. Although the cost of borrowing capital may have a generalized effect upon prices in the market place, here petitioner contends that purchase price or value has a direct relationship to interest rates. As a premise, petitioner defines a range of interest rates from which persons may choose to finance an investment. The lower end of this spectrum is the rate set in section 483.[16] Any lower interest rate and part of

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[16] Petitioner's theory assumes that the minimum rate acceptable for tax purposes under sec. 483 has some relevance as a starting point for interest rates. Possibly petitioner's premise is based on the consideration that a seller would have to report "implied interest" for tax purposes if he agreed to interest at an amount less than the minimum rate set in sec. 483. This consideration, however, has no apparent or logical connection to the amount of interest charged by an independent lender of capital. This would seem to be especially true

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the price will be recharacterized as interest. The highest interest rate is at or near market rates. Any higher, and as a practical matter, the investor merely refinances at more favorable rates.

Petitioner's interest rate premise serves as the foundation for his "fulcrum principle." Petitioner asserts that the purchaser of an income producing asset is willing to pay a premium purchase price for below-market financing. In other words, the lower the interest rate used to finance the purchase, the higher the value, and vice versa. Petitioner further suggests that the seller is willing to accept these terms because he receives the same amount because of the inversely proportionate relationship between the interest rate and purchase price. For example, $1,000,000 financed at 9 percent for 20 years is the equivalent of $1,365,185 financed at 5 percent for a like term. Both will be completely amortized by payments of $109,546 per year over the term. Petitioner argues that favorable under-market seller financing increases the fair market value of the asset. He argues that fair market value should be redefined to mean value *as financed*. While we find petitioner's argument novel and on the surface appealing, we do not adopt it for purposes of determining fair market value.

Fair market value is the price at which property would change hands, between a willing buyer and a willing seller, neither being under any compulsion to buy

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where there is a large spread between the sec. 483 minimum rate and the prime rate (the rate banks charge to their most creditworthy borrowers).

or to sell and both having reasonable knowledge of relevant facts. Sec. 1.170A-1(c)(2), Income Tax Regs.; sec. 20.2031-1(b), Estate Tax Regs.; Chiu v. Commissioner, 84 TC 722, 730 (1985). For the following reasons, we hold that petitioner's concept of "under-market seller financing" is irrelevant in determining fair market value.

A seller-financed transaction is the amalgam of two distinct transactions. First, there is a transfer of the asset from the seller to the buyer. Then, there is a "loan" from the seller to the purchaser of all or a portion of the purchase price. If the "loan" is at rates that are under market, the seller/lender will generally lose money on the loan part of the transaction. Theoretically, the difference may be adjusted in the purchase price as between a particular seller and buyer. This adjustment is the factor that petitioner contends increases fair market value.

It is reasonable to state that a particular purchaser may be willing to pay more if provided with under-market seller financing. Although the extra amounts may be labeled as principal, in reality they constitute amounts paid for the use of money or interest.[17] See Deputy v. duPont, 308 U.S. 488, 498 [23 AFTR 808] (1940); Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560 [10 AFTR 786] (1932). Conversely, if a seller is willing to

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[17] There may be no tax difference where parties convert interest into principal by reducing the stated interest rate on an obligation. This is so because the principal would be depreciable over the life of the asset and interest on the note deductible over the term of the note. Although the so-called "passive loss" rules of the 1986 Tax Act may have some affect on the above-stated theorem, such rules were not effective for the years here in issue.

provide under-market financing it may be an indication that the value of the asset is less than the stated price. As petitioner has amply demonstrated, there is no economic difference between market and below-market rates that is not made up by the price differential. Petitioner has failed to prove that there is any incremental fair market value from below-market financing beyond the difference between market and below-market interest.

Petitioner contends that below-market interest causes a more rapid equity buildup that enhances value. While this is true, quicker equity buildup is correspondingly subject to a larger total debt amount and thus they are relatively approximately equal.[18] In any event, petitioner has not successfully quantified the effect, if any, this difference would have on value in the context of this case.

Petitioner referenced several cases in support of his proposition that favorable seller financing impacts on fair market value. In Mayerson v. Commissioner, 47 TC 340 (1966), we held that a 99-year note given to purchase a building requiring minimal principal payments was nonetheless valid indebtedness that could be included in the taxpayer's basis in the building. The parties negotiated a cash price of $275,000, or a financed price of $332,000. If the buyer could obtain refinancing within 3 years, the note could be prepaid at a discount. In Curry v. Commissioner, 43 TC 667 (1965), we upheld the sale of a building to a corporation related to the sellers against a

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[18] Hypothetically, below-market interest debt will generate slightly more rapid relative equity buildup (equity divided by original principal) than debt at the market rate.

claim that it was a section 351contribution with the interest representing dividends to the sellers. In that case we commented, "The fact that a fair cash price * * * would have been less than [the purchase price] is of little significance. There is quite a difference between a cash sale and a sale on terms." Curry v. Commissioner, supra at 694. In Commissioner v. Brown, 380 U.S. 563 [15 AFTR2d 790] (1965), affg. 325 F.2d 313 [12 AFTR2d 6095] (9th Cir. 1963), affg. 37 TC 461 (1961). The Supreme Court upheld the sale of a business, affirming our findings that the sales price was "within a reasonable range" of the appraised value. The price in that case was paid by a 10-year non-interest-bearing note. See also Union Bank v. United States, 285 F.2d 126 [7 AFTR2d 503] (Ct.Cl. 1961).

There are a number of distinguishing characteristics between those cases and the instant case. In each of the cited cases the courts found that the sales were the results of arm's-length negotiations. We do not unqualifiedly make such findings here. (See discussion on "arms length dealing" infra.) The courts in the cited cases did not attempt to specifically evaluate the effect, if any, favorable financing had on value, because the price was considered to be in a normal or reasonable range. In addition, in Curry we specifically made no finding as to fair market value. In Mayerson, it appears that the interest rates charged were not below market, thus there was no favorable financing. Moreover, none of the cases involved price to fair market value (or cash price) ratios in excess of 130 percent.

In another vein, the cited cases are somewhat different because they were decided in a different economic climate. Twenty to twenty-five years ago interest rates

were, at most, 5 or 6 percent. the range available for economic maneuvering was small when compared to the period under consideration. During the years in issue, the prime rate had begun to climb precipitously, and would eventually exceed 20 percent.

Finally, in a recent case we implicitly rejected notions that fair market value may be based upon or is theoretically supported by favorable seller financing. In Goldstein v. Commissioner, 89 TC 535 (1987), the taxpayers purchased a number of posters and subsequently donated them to a charitable organization. The purchase price was $20,000, $4,000 cash and promissory notes bearing interest at 9 percent, at a time when the prime interest rate was near 20 percent. We decided fair market value of the posters by discounting the notes to present value (using market or prime interest rates) and adding that value to the cash outlay. In Goldstein we found that the fair market value of the posters was $4,816. This holding neutralizes the artificial effect that financing could have upon fair market value.[19]

Petitioner has confused price with fair market value. Below-market financing merely is a conversion or exchange of interest and principal. For the foregoing reasons, the fair market value of the properties must be segregated from the concept of financing the "purchase."

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[19] The fact that the interest rate charged exceeded the test rate under section 483 did not affect our conclusion with regard to fair market value. Goldstein v. Commissioner, 89 TC 535, 547 n. 15 (1987).

There are three basic methods used to value real property (or other assets). The comparable sales method involves comparisons of the subject property to similar properties sold in the same time frame and geographic area. The replacement cost method values the property based on the cost of replacing the land and building currently less an allowance for depreciation. The income forecast method involves discounting to present value the expected income from the property.

In the case of property subject to long term net leases, the income forecast method is the most suitable method of valuation. This method involves discounting to present value the stream of future rental payments. In addition, if the "purchaser" has a reversion after the lease expires, the reversion must be valued. Thus, the two elements to be valued are cash flow and future appreciation. See Hilton v. Commissioner, 74 TC 305 (1980), affd. 671 F.2d 316 [49 AFTR2d 82-1060] (9th Cir. 1982). We have assumed that petitioner either owned or had an option to purchase the reversionary interest, even though the existence of these purchase options is less than clear.

In determining the income stream, the rentals under the contract were reduced by ground rents and maintenance charges, if any. In valuing the properties, we assumed that the partnerships would receive the rental payments (reduced by maintenance charges and ground rents), even though Penner actually received the rentals as payments on the purchase price. We valued the reversions by projecting the rentals for a number of years (between 30 and 40) beyond the initial lease term, either under the lease renewal terms, or by assuming an increase of 3 percent a year in the base rental rate. This

was discounted back to the end of the first lease term, and then discounted back to the point of purchase.[20]

The discount rate applicable to the income stream is a major determinant of value. The discount rate is a function of the risk of the venture and the general rate of inflation. It takes into account the general risks involving income-producing real estate: that the lessee will not renew and any attendant temporary vacancies; any decline in the rate of rentals in the areas; business failure by the lessee; etc. The riskier the venture the greater the rate of return necessary to compensate for that risk. Because the tenants were long term and credit worthy, the investments are of relatively low risk However, the income stream is fixed by the lease terms. In a similar manner as fixed income instruments, increased external interest rates decrease market value. Further, there is

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[20] The reversions were valued using the same discount rates used to value the cash flows with the following variables:

Property	Annual Renewal Rentals	Term
Duluth	$112,500	40 Years
Hacienda	165,000	30 Years
Seaside	300,000	30 Years
Bethlehem	900,000	38 Years
Progressive	277,000	30 Years

We think it is appropriate that the same discount rate be applied to both the income stream and the reversion. Even though making projections that far into the future is very speculative, as both experts pointed out the reversions are sufficiently far off into the future (21 to 29 years) that errors in the reversion values do not make that much of a difference. The reversions normally made up only about 15 percent of the value of a property.

additional risk usually associated with leveraging (borrowing money to finance) an investment. Leveraging can multiply the rate of return under favorable circumstances, but it will also multiply the negative rate of return if the investment sours. Thus, the risk of this venture is similar to that of a corporate bond or a commercial mortgage. We adopt respondent's expert's approach of using a discount rate approximating the rate for mortgages for commercial service property (Hacienda, Bank of Florida, Progressive) or office buildings (Bethlehem), except as to the Duluth Post Office. For that property, respondent's expert used a rate slightly higher than the corporate AAA bonds rate, because the income stream is safer. We agree.[21]

Petitioner argues that we should use a discount rate equal to the rate of financing.[22] This is simply a correlative way of stating an argument we have already rejected – that below market financing increases fair market value.

Set forth below are the fair market values we have found, along with petitioner's and respondent's experts' conclusions, and their respective price to fair market value ratios:

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[21] The discount rates used are as follows: Duluth – 8.2 percent; Hacienda – 9.5 percent; Seaside – 9.5 percent; Bethlehem – 9.75 percent; Progressive – 10.75 percent.

[22] Petitioner's expert used a blended rate to take account of the fact that the rates were at market for the first 3 years.

Property	Price	FMV	Ratio	Petitioner	Ratio	Resp.[23]	Ratio
Duluth	$ 2,301,000	1,338,855	172%	$ 1,730,000	133%	$1,310,000	176%
Hacienda	1,161,900	740,677	157%	1,080,000	108%	735,000	158%
Seaside	2,259,900	1,397,897	162%	2,390,000	95%	1,260,000	179%
Bethlehem	12,500,000	9,010,991	139%	11,000,000	114%	8,000,000	156%
Progressive	1,690,000	980,025	172%	1,130,000	150%	994,000	170%

[23] For properties where respondent's expert did not originally include the reversion in petitioner's interest, (Hacienda, Seaside, Progressive) we added the value of the reversion as computed in the original expert report.

Thus, even using assumptions highly favorable to petitioner (except as to discount rates), petitioner's claimed price ranged from 39 to 72 percent more than fair market value. Further, we did not include in the price the cost to purchase the reversions (for properties with only ground leases).[24] Nor did we reduce from our value determination the legal and administrative expenses that would have some effect on return, and, therefore, on fair market value. These amounted to substantial sums, as evidenced by amounts deducted on the partnership returns. In addition, we find it relevant that price even exceeded value *"as financed,"* as defined by petitioner's expert, by 8 to 50 percent.[25] While the price to fair market value ratios in this case are not inherently egregious,[26] the difference in absolute terms amounts to hundreds of thousands of dollars.

Respondent's experts also expressed replacement cost and market comparison valuations that correspond with and support the income approach figures. In addition, we find it highly relevant that the purchase prices

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[24] The purported option amounts to purchase the reversions were as follows: Hacienda, $243,000; Seaside, $375,000; Progressive, $530,000. This would increase the price to fair market value ratios to 190 percent, 188 percent, and 226 percent, respectively.

[25] This may have been due to the fact that the interest ran at market rates for the first 3 years. In an apparent attempt to maximize interest deductions, petitioner reduced the value of the properties "as financed."

[26] We have considered cases, where price was inflated 20 to 50 times over fair market value. See, for example, Soriano v. Commissioner, 90 T.C. 44 (1988).

greatly exceeded the price paid by the Penners for the properties, even where the two purchases occurred within a short time of each other. While we do not expect the seller to sell at his cost, it seems less likely that the properties appreciated to the extent proposed by petitioner in the short time (usually less than 3 years) between Penner's purchase and resale. The purchase price for the Duluth Post Office in 1977 exceeded the lessee's option price in the year 2000, 23 years later. This option would likely diminish, if not eliminate, a purchaser's opportunity to benefit from any future appreciation.

We find that the purchase price exceeded a "demonstrably reasonable estimate of the fair market value." Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 [38 AFTR2d 76-6164] (9th Cir. 1976); Narver v. Commissioner, 75 T.C. 53 (1980), affd. per curiam 670 F.2d 855 [49 AFTR2d 82-1020] (9th Cir. 1982).

Arm's-Length Negotiations

Although petitioner and Penner negotiated about the terms, including price and down payment, in the context of this case we do not find this relationship to be at "arm's length" in the ordinary sense of that term.[27]

[27] The negotiations were not at "arm's length" in the same sense as those between a "willing buyer and seller" necessary for the determination of fair market value. In this regard, perspective is affected by the fact that this was not a cash transaction. It was two separate transactions merged to produce a specialized result, which did not necessarily reflect the fair market value.

Petitioner and Penner were not ordinary "willing buyers and sellers" in an open market situation. They, instead, were agreeable to specialized transactions orchestrated to produce a financial solution and tax result. Penner was apparently interested in raising capital in a market where interest rates were on the rise and petitioner in obtaining tax benefits for his clientele.

First the parties agreed upon a cash price,[28] and then petitioner would submit the transaction with terms. Once the parties agreed upon a cash price – except to the extent that it was necessary to negotiate the amount of the down payments – it is doubtful that they were truly dealing at arm's length. In a seller-financed transaction at market rates, the seller would intend to realize a gain on the sale of property plus annual interest income. For the years involved the gain from the property sale would probably be subject to favorable tax treatment – capital gains rates and installment sale treatment. The interest portion is ordinary income. It usually is in the seller's interest to increase the favorably taxed portion, thus it usually is better to increase the purchase price at the expense of a few percentage points of interest. The buyer here was also receptive to such treatment. While he loses an increased interest deduction, this is made up by the

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[28] Agreeing upon a price, in the context of this case, was the equivalent of agreeing upon the amount of "up-front" cash to be received by Penner during the first few years of each transaction. The notes were paid up by a conduit-like flow through of the lessee's payments to Penner or to the first lien holder, without profit or positive cash flow to petitioner's investors.

increased deduction for depreciation. The increased purchase price results in a potentially increased depreciable cost basis. See secs. 167, 1001, 1012.

In this scenario, petitioner also would have been entitled to increased interest deductions, attributable to market rates at the beginning of the term. The accrual basis partnerships could deduct such amounts, whether actually paid or not. The Penners would not have to report such income until actually received if, assuming as we do for purposes of this illustration, they were on the cash method of accounting. "An allocation by a buyer and a seller will be ignored if it is * * * not a result of arm's length negotiations between parties with adverse tax motivations." Landry v. Commissioner, 86 T.C. 1284, 1307 (1986). (citations omitted.) Thus, using these objective indicia, we find that petitioner and Penner were not dealing at arm's length.

Financing

Petitioner touts his concept of "below-market financing" as the foundation and substance for these transactions. We think the financing method reflects an absence of arm's-length dealing.

The transactions were purposely structured so that the partnerships did not receive any cash flow. All the rentals went to the Penners (as they had before the transaction) as either payments on notes, maintenance fees or ground rents. This places petitioner's chances for economic profit solely on the possibility of appreciation in value of the underlying properties, which is lessened by

the artificially large purchase price. In addition, the Penners were in essentially the same position as if they had not sold the property – they received the rentals and paid the underlying senior indebtedness. Additionally, they received part of the cash contributed to each partnership in the form of a down payment.

For four out of five of the properties, there was negative amortization – the interest accruing on the debt exceeded the payments. Thus, until the balloon payments were made (at a time remote to the inception of the transactions), petitioner and the investors had no equity in the property. Depreciation would be based upon a seemingly illusory investment in property, where payments of the purchase price yielded no equity to the purchaser. Estate of Franklin v. Commissioner, supra at 1049.

The balloon payments also arouse some suspicion. These payments, usually due 10 to 15 years after the purchase, were two to four times the amount of the original down payments. Because the properties yielded no cash flow, the investors would have to come up with this money from other sources.

There also appears to be no business purpose for the interest rate differential. The interest ran at market rates for 3 years and then dropped to a level well below market. While petitioner claims that the below-market financing increased the value of the property (a contention we do not accept), there does not appear to be any non-tax justification for the variations and the market interest in the initial three years.

Given our finding that the prices exceeded fair market value by 39 to 72 percent, it is highly unlikely and beyond reasonable speculation that the value of the properties would appreciate to generate sufficient funds to repay the indebtedness and generate a profit. With nonrecourse financing "the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase." Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 [38 AFTR2d 76-6164] (9th Cir. 1976).

In appendix A of his brief, petitioner attempts to show that the transactions were economically viable. He asserts that the out of pocket moneys paid by investors, increased at a "desired rate of return," would equal the future value of the properties after all payments were made. This future value was computed by applying "modest" inflation rates – 3 to 7 percent – to respondent's expert's valuation. Petitioner has presented a clever but superficial approach. A primary defect in his approach is that the rates of desired return were less than the discount rate. The justification for this was that a reasonable investor would take into account tax benefits in computing return, thus using a lower rate would be justified. Even if we could accept this reasoning, which we cannot (see Herrick v. Commissioner, 85 T.C. 237 (1985), holding that profit in the first instance means economic profit, independent of tax savings; Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988), holding that tax credits cannot be taken into account in determining economic profit), petitioner has not laid an adequate foundation for reducing the discount rate to take into account

tax benefits. It appears that the 2 or 3 percentage point reduction was arbitrary.

In addition, we do not approve or sanction petitioner's computation of the future value of the buildings. Petitioner simply applied "modest" rates of inflation to respondent's computed values. It is clear that the underlying leases, not the general rate of inflation, would be the major determinant of value. For example, in the Duluth transaction, the rentals were fixed through the year 2040. Similarly, the First Valley Bank had options to renew through the year 2038. Due to the fixed nature of the lease payments, external interest rates would have a significant effect on value. Finally, there are a number of other factors – financial condition of the lessee, condition of the neighborhoods, condition of the buildings – that would also have an effect on value.

Other Factors

Future appreciation in value was the only possibility for investors to receive an economic return from these transactions. Given the fixed rental payments in the underlying leases, petitioner could only expect to benefit from appreciation at a time remote to the inception of the transactions. *So long as interest rates remain constant, or increase, there will be no significant appreciation in the value of the properties until at or near the time they are freed from the constraints of the underlying leases.*[29]

[29] With respect to the Duluth Post Office, it is difficult to see how petitioner could benefit from any appreciation. The

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For the properties subject to ground leases, the documents of purchase expressly stated that the improvements would revert to the Penners at the end of the ground lease term. Considering the critical importance of these reversion purchase options, it is suspicious that: (1) The only documentation for the Seaside option was a letter written 3 years after the date of purchase; (2) the documentation for the Progressive option is dated "November ___, 1980;" and (3) there is no documentation for the Hacienda Bank option.

Whether legal title passes has been one factor used by courts in determining whether a sale has occurred. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). However, the simple expedient of drawing up papers is not controlling for tax purposes, and we must look to the objective economic realities rather than the form the parties employ. Commissioner v. Tower, 327 U.S. 280 [34 AFTR 799] (1946). In cases like this one, the relationship of price to fair market value and the character of the debt are more reflective of the economic realities than whether or not a deed is recorded. Although the documentation used in these transactions was relatively thorough and complete, there were "telltale" signs of "tax shelter modus operandi." For example, the documentation for these transactions almost always

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United States had an option to purchase the property at the end of the renewal terms for approximately $4.4 million dollars. The partnership paid $2.3 million dollars in 1977 for its one-half interest. If the property appreciated to any significant extent, the United States could exercise its option and the partnership would no longer own the property.

bore execution dates in December and were made effective as of dates 6 months to 12 months earlier. If, as asserted, the deals were substantially closed as of these dates, it is curious that the documentation was still interlineated and rather informal in December.

In correspondence to investors, petitioner referred to these undertakings as tax-oriented ventures. In informing investors that they had purchased a particular property, special mention was made as to the amount of loss per $15,000 investment.[30]

Therefore, from several perspectives used to analyze these transactions, we find that no sale occurred for income tax purposes; that there was no bona fide non-tax profit objective; and that no genuine indebtedness was created. Thus, petitioner is not entitled to the claimed "losses" from these partnerships. Estate of Franklin v. Commissioner, supra; Soriano v. Commissioner, 90 T.C. 44 (1988); Cherin v. Commissioner, 89 T.C. 986 (1987); Rose v. Commissioner, 88 T.C. 386 (1987); Zirker v. Commissioner, 87 T.C. 970 (1986).[31]

Gross Income

The next issue is whether petitioner is required to recognize income upon the receipt of the partnership

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[30] For the first 3 years, the cumulative loss to cash investment ratio was about 2:1.

[31] If, at some future time, the properties appreciate so as to make payment of the purchase price reasonable, it is possible that a sale might occur at that time. We do not need to address that issue in this proceeding.

interests. Gross income includes compensation for services. Section 61. Thus, the receipt of a partnership interest in exchange for services generates taxable income. Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974), affg. 56 T.C. 530 (1971). While petitioner argues that he received only an interest in profits and losses, the partnership returns indicate that he had a percentage capital interest as well. Further, petitioner testified that he would share in any appreciation in value of partnership property, subject only to the right of the partners to first receive back their cash contributions. Thus, he did have an interest in partnership capital, in addition to profits and losses.

However, because the partnerships did not engage in "sales" for income tax purposes, they did not really acquire property. Partnership capital contributions were paid over to Penner as down payments or to others as administrative expenses. Thus, the interests received by petitioner in these partnerships were of no value or worthless (except for the potential of tax benefits), and no income was realized.

Negligence

The next issue involves whether petitioner is liable for the section 6653(a) addition for negligence. Negligence, within the meaning of section 6653(a), is the lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985). Petitioner argues that he had a good faith belief that the

properties would appreciate in value, producing economic benefits, and that this was enhanced by substantial leverage and favorable seller financing. From our perspective the transactions were not reasonable. That does not, however, render petitioner's theory untenable. Although we rejected petitioner's favorable financing argument, it is not without some support in the case law. See, e.g., Mayerson v. Commissioner, 47 T.C. 340 (1966). Because the claimed losses were supported by a credible and unprecedented (albeit erroneous) theory, we decline to sustain the section 6653(a) additions to tax.

Valuation Overstatement

The next issue is the addition to tax determined for valuation overstatements. Section 6659 provides for an addition to tax equal to 30 percent of the underpayment attributable to an overvaluation of more than 250 percent. Sec. 6659(a), (b). A valuation overstatement occurs if the adjusted basis of any property claimed on a return exceeds 150 percent of the amount determined to be the correct amount. Sec. 6659(c). The partnerships claimed an adjusted basis on the returns equal to the purchase prices. Since no sales are recognized for tax purposes, the correct adjusted bases are considered to be zero. See Zirker v. Commissioner, supra at 979. Thus, the underpayments attributable to the disallowed depreciation deductions would, absent section 6659(c)(2), be subject to a 30-percent addition for overvaluation.

Prior to its repeal by the Tax Reform Act of 1984, section 6659(c)(2) provided that section 6659 would not apply to any property which, at the close of the taxable

year, *was held by the taxpayer more than 5 years*. The repeal is only effective for returns filed after December 31, 1984. Pub. L. 98-369, section 155(c), 98 Stat. 693. Although we have decided that petitioner was not entitled to the claimed losses from these partnerships because we found that no sale occurred for income tax purposes; that there was no bona fide non-tax profit objective; and that no genuine indebtedness was created, we have not found, in the ordinary sense, that the investors *did not hold the property*. Petitioner's claimed losses are, in large part, dependent upon the depreciation allowance of section 167. The allowance of depreciation under section 167 relates to "property *used in the trade or business*, or * * * property *held for the production of income*." (Emphasis supplied.) We have found that the property was not held for profit and that the transactions should not be given effect for tax purposes, but that is not to say that petitioner and other investors did not own or "hold" the real property in question.

Section 6659(c)(2) was Congressionally designed as an escape clause from the application of the section 6659 addition to tax. The provision is purposely phrased to permit "relief" from the addition to tax if the property was held more than five years. No modifiers, one way or the other, were included to limit the "escape clause" to a particular class of taxpayer. Although petitioner's "holding" of the properties has not been recognized for tax purposes, the properties have nevertheless been "held" by petitioner and the partnerships. To interpret these provisions based upon the method or type of underlying determination or disallowance is not justified considering the simple use of the term "held." Under the statutory

provisions, the relief was available even though a taxpayer otherwise fell within the statutory provisions providing for an addition to tax for valuation overstatement. Thus, section 6659(c)(2) would apply for those partnerships or partners who held the property for more than five years and whose tax return was filed before December 31, 1984. Accordingly, with respect to properties acquired before December 31, 1977, (Hacienda, Bank of Florida, Duluth) section 6659 would only apply to 1981 taxable year.

Additional Interest – Section 6621

The final issue is the additional interest imposed on tax motivated transactions by section 6621(c). The increased rate of interest is 120 percent of the statutory rate imposed on underpayments. Sec. 6621(c)(1). A tax motivated transaction includes any valuation overstatement, as defined in section 6659. Sec. 6621(c)(3)(A)(i). In addition, section 6621(c)(3)(A)(v) includes sham or fraudulent transactions within the scope of the additional interest section. Included in such transactions are those entered into without a profit motive and which were without economic substance. Patin v. Commissioner, 88 T.C. 1086 (1987), affd. sub nom. Hatheway v. Commissioner, 856 F.2d 186 (4th Cir. 1988), affd. sub nom. Skeen v. Commissioner, ___ F.2d ___ (9th Cir. 1989). See also sec. 301.6621-2T Q4, Temp. Proced. and Admin. Regs., 49 Fed. Reg. 59394 (Dec. 28, 1984); Cherin v. Commissioner, supra. Because the underpayments in this case were attributable to valuation overstatements, and transactions lacking in economic substance and profit objective, the

additional interest applies. To reflect the foregoing and concessions of the parties,

Decisions will be entered under Rule 155.

APPENDIX B

UNITED STATES TAX COURT
Washington, D.C.

SOL FINKLEMAN, Petitioner,	)	
v.	)	Docket Nos. 7581-86
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	34999-86

ORDER

Petitioner, in his Motion For Leave To File A Motion For Reconsideration of our Memorandum Opinion (T.C. Memo. 1989-72, filed February 16, 1989), filed June 27, 1989, advanced reasons in support of his motion, amongst which we found one to be salient, to wit: to provide us with the opportunity to determine whether the holding in *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988), might have an effect upon the holding in our Memorandum Opinion. The parties in this case did not cite *Pleasant Summit Land Corp. v. Commissioner, supra*, in their briefs and this Court did not consider it in rendering the Memorandum Opinion. Respondent, by a written document filed July 24, 1989, objects to the granting of petitioner's motion.

After considering the holding of the Court of Appeals for the Third Circuit; reviewing the facts in this case; considering that this case would be appealable to the Court of Appeals for the Ninth Circuit, see *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985

(10th Cir. 1971), cert. denied 404 U.S. 940 (1971); and recognizing that petitioner's Motion For Leave To File A Motion For Reconsideration is nearly 100 days beyond the 30 day period permitted in Rule 161 of the Court's Rules of Practice and Procedure, it is

ORDERED that petitioner's Motion For Leave To File A Motion For Reconsideration is denied and it is further

ORDERED that the parties shall submit their agreed or unagreed computations under Rule 155 of the Court's Rules of Practice and Procedure, on or before September 15, 1989, and any party who has not supplied a computation shall on or before September 15, 1989, submit a report, in writing, to the Court advising of the reasons for delay and a projected date by which such computation will be submitted. It is further

ORDERED that in addition to regular service, the clerk of the Court is directed to service a copy of this order on Hochman, Salkin and Deroy, Seventh Floor, West Tower, 9100 Wilshire Boulevard, Beverly Hills, California 90212.

(Signed) Joel Gerber

Joel Gerber
Judge

Dated: Washington, D.C.
August 3, 1989

APPENDIX C

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SOL FINKELMAN, Petitioner, v. COMMISSIONER INTERNAL REVENUE SERVICE, Respondent.	NO. 90-70050 Tax Court No. 7581-86 MEMORANDUM* (Filed July 10, 1991)

Appeal from Internal Revenue Service

Argued and Submitted April 9, 1991
San Francisco, California

Before: WALLACE, Chief Judge, GOODWIN, and FLETCHER, Circuit Judges.

The judgment of the Tax Court is affirmed for the reasons set forth in that court's February 16, 1989 memorandum opinion (TCM 1989-72).

AFFIRMED.

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this Circuit except as provided by Ninth Circuit Rule 36-3.

APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SOL FINKELMAN, Petitioner, v. COMMISSIONER INTERNAL REVENUE SERVICE, Respondent.	NO. 90-70050 D.C. #0971-3: 7581-86 ORDER (Filed Sept. 11, 1991)

Before: WALLACE, Chief Judge, GOODWIN, and FLETCHER, Circuit Judges.

The petition for rehearing is denied.

APPENDIX E

PLEASANT SUMMIT LAND CORPORATION,
Appellant in 88-1373,

v.

COMMISSIONER OF INTERNAL REVENUE.

George PRUSSIN and Sharon Prussin,
Appellants in 88-1377,

v.

COMMISSIONER OF INTERNAL REVENUE.

Nos. 88-1373, 88-1377.

United States Court of Appeals, Third Circuit.

Argued Oct. 7, 1988.

Decided Nov. 25, 1988.

Opinion on Denial of Rehearing in No. 88-1377
Jan. 30, 1989.

Paul Windels, Jr. (argued), John Y. Taggart, Clayton A. Prugh, Windels, Marx, Davies & Ives, New York City, for appellants.

William S. Rose, Jr., Asst. Atty. Gen., Gary R. Allen, Jonathan S. Cohen (argued), Michael J. Roach, U.S. Dept. of Justice, Tax Div., Washington, D.C., for appellee.

Before HIGGINBOTHAM, MANSMANN and GREENBERG, Circuit Judges.

OPINION OF THE COURT

GREENBERG, Circuit Judge.

Appellants, Pleasant Summit Land Corporation (PSLC) and George and Sharon Prussin, appeal from adverse decisions entered by the Tax Court following a

consolidated trial on their petitions to redetermine deficiencies determined by the Commissioner of Internal Revenue. PSLC challenges the Tax Court's conclusion that it was a "personal holding company" subject to the tax on personal holding companies in its tax year in issue. Resolution of its appeal depends on whether its sale of the Summit House apartments in West Orange, New Jersey, was of a capital asset and thus resulted in a capital gain or whether the Summit House was a property it held primarily for sale to customers in the ordinary course of its trade or business so that its sale resulted in ordinary gross income.

George Prussin is an investor in a limited partnership, Pleasant & Summit Associates (PSA), which indirectly purchased Summit House from PSLC. The Prussins challenge the Tax Court's conclusions that: (1) nonrecourse financing of the Summit House purchase exceeded its fair market value; (2) the nonrecourse financing would not support depreciation and interest deductions which they claimed by reason of George Prussin's limited partnership interest in PSA; and (3) these deductions would be disallowed in full rather than only to the extent that they were the product of financing in excess of the fair market value of Summit House. Furthermore, they argue that the complete disallowance of the deductions unconstitutionally violated their right to due process of law.

This court has jurisdiction under section 7482(a) of the Internal Revenue Code of 1954.[1] The Tax Court had

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[1] The years with respect to which tax liability is contested predate the enactment of the Tax Reform Act of 1986, Pub.L.

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jurisdiction under I.R.C. §§ 6213(a), 6214(a), and 7442. Inasmuch as PSLC was a New Jersey corporation with its principal place of business in New Jersey when it filed its petition and filed its appeal to this court and the Prussins were a married couple residing in New Jersey at all times relevant to their petition and appeal, the venue for these appeals properly lies in this court.[2]

(Continued from previous page)

No. 99-514, 100 Stat. 2085. Thus, while that Act redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986, *see id.* § 2, we refer throughout this opinion to the 1954 Code which governs the substantive issues.

[2] A related case, *Estate of Isaacson v. Commissioner*, 2d Cir., Docket No. 88-4062, arising from the same transaction but involving different taxpayers, was appealed to the United States Court of Appeals for the Second Circuit. In this related case, the estate of Melvin W. Isaacson and Miriam A. Isaacson appealed from a decision disallowing deductions for depreciation and interest based on Melvin Isaacson's ownership of two limited partnership units in PSA. Venue for the Isaacson appeal lay to the Court of Appeals for the Second Circuit rather than to this court because the Isaacsons resided in Connecticut at the time their tax court petitions were filed. I.R.C. § 7482(b). PSLC and the Prussins in their brief recite that the Commissioner "would not consent to a consolidation of these appeals." On October 24, 1988 the court affirmed the Isaacson appeal in a per curiam opinion for the following reason: "We agree with the reasoning and conclusions of the Tax Court, and, for the reasons set forth in Judge Cohen's thorough opinion, the judgment of the Tax Court is affirmed." 860 F.2d 55. Notwithstanding the opinion of the Court of Appeals for the Second Circuit, we have independently arrived at our result which is partially different. We note that in its brief recitation of the facts, the Court of Appeals for the Second Circuit indicated that $500,000 was paid in cash by PSLC for the original purchase. We are confident that the correct figure was $250,000, as set forth by Judge Cohen.

We will affirm the Tax Court's decision with respect to PSLC. We will reverse the Tax Court's decision to the extent it completely disallowed the Prussins' deductions and will remand for a determination of the fair market value of Summit House and for calculation of the appropriate deductions allowable to the Prussins. Since we hold that the Prussins' deductions may be disallowed only in part, their constitutional claim is moot and we do not address it.

I. BACKGROUND

A. *The Underlying Business Transaction*

On May 3, 1978, in an arm's length transaction, PSLC entered into an agreement to purchase the Summit House, a property on Summit Street, West Orange, New Jersey, containing two apartment buildings and a small separate resident manager's apartment for $4,200,000. The purchase was closed on or about June 1, 1978 and the consideration was paid by $250,000 in cash, by delivery of a $1,350,000 note secured by a purchase money mortgage, and by PSLC taking title subject to a previously existing $2,600,000 nonrecourse mortgage.

Contemporaneously with the purchase, PSLC created a wholly owned subsidiary, Mount Orange Realty Corp. (MORC), to which it then sold the Summit House building while retaining the land beneath them. The sale price to MORC was $5,200,000, consisting of $500,000 in cash which MORC borrowed or owed and a $4,700,000 nonrecourse mortgage which wrapped around and was

subject to the prior two mortgages.[3] The note which this mortgage secured permitted accumulation of interest and principal through December 31, 1988, except that annual interest payments were required up to the available cash flow. This conveyance of the property placed the depreciable buildings in one entity while leaving the nondepreciable land in another.

PSLC then sold its MORC stock to the newly created PSA, which was organized to acquire the Summit House, for $2,559,200, paid in the form of a nonrecourse note secured by the MORC shares, for which a mortgage of Summit House to PSLC was immediately substituted. This note had provisions for accumulation of interest and principal through December 31, 1988, similar to those in the $4,700,000 note. PSA then dissolved MORC, took direct ownership of the Summit House buildings and took over MORC's obligations including the $500,000 due on the purchase of the Summit House and the $4,700,000 nonrecourse wraparound mortgage. Thus, the cost to PSA for acquisition of Summit House was the $2,559,200 indebtedness for the purchase of the MORC shares, assumption of MORC's $500,000 obligation, and assumption of MORC's $4,700,000 nonrecourse wraparound mortgage for a total of $7,759,200. The record, however, does not clearly establish that PSA paid the $500,000. Of

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[3] The $500,000 was not paid by MORC. A pretrial stipulation indicated that it was to be paid but does not indicate that this happened. In their brief, appellants suggest it was borrowed and was thus owed. It should be noted that the consideration in the PSLC and MORC purchases was divided between personal property and real estate but the allocation is not significant for our purposes.

course, this assumption of obligations did not transform the nonrecourse debts to recourse obligations. The consequence of these transactions was to leave PSA with large debts with interest charges and a substantial depreciable asset, a situation setting up the possibility for it to claim large tax deductions. Additionally, PSLC leased the land under the buildings to PSA for $10,000 a year under an agreement allowing rent to be accumulated and deferred at a fixed rate of interest. This provision caused PSA to generate additional tax deductions for the interest which accrued on the unpaid rent.

PSA sold thirty limited partnership units to a group of investors including George Prussin for a total of $1,980,000 paid with down payments and subsequent installments. The offering memorandum to the investors indicated that the $500,000 due on the sale from PSLC would be paid from the investors' down payments, leading the Commissioner in his brief to indicate that it appears that MORC's $500,000 obligation for its down payment was satisfied from the investors' funds. Inexplicably, the agreement for sale of the MORC shares between PSLC and PSA included a warranty by PSLC that MORC had no liabilities. Some months after PSA acquired Summit House, a new nonrecourse mortgage was substituted for the prior $2,600,000 mortgage but this did not enhance PSA's risk in the transaction. Most of the foregoing transactions were nearly contemporaneous and thus they formed part of one large structured undertaking.

PSA reported losses on its income tax returns for 1978 and 1979, and later years, largely attributable to interest deductions and depreciation. These losses were

passed through to the limited partners who used them to off-set income on their individual tax returns. On December 19, 1985 an unrelated third party purchased the Summit House land from PSLC and the buildings and lease from PSA for a total of $7,000,000.

B. *The Assessment of Deficiencies Against PSLC*

On its corporate income tax return for its taxable year ending May 31, 1979, PSLC indicated that: (1) it had realized a gain of $3,742,704 on the sale of certain improvements to land in West Orange, New Jersey (Summit House); (2) it elected to use the cost recovery method for reporting this profit; and (3) under this method none of the gain was includable in its gross income for the taxable year covered by the return.

On October 7, 1982, the Commissioner issued a deficiency notice to PSLC. This notice stated that: (1) PSLC was required to recognize gain on the sale of its real property in the year of the sale;[4] (2) PSLC was not

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[4] In the Tax Court opinion the judge refers to the gain on the sale of Summit House by PSLC as being on a sale *to* MORC but the parties refer to it as being on the sale to PSA and, therefore, in effect, being *of* MORC. Thus, PSLC in its brief, in an assertion that the Commissioner does not challenge, indicates that "the Commissioner determined that PSLC realized a capital gain of $3,742,704 from its sale of Summit House to PSA of which $464,069 was recognizable in PSLC's taxable year ending May 31, 1979, because of the application of the installment method. Although PSLC's sale was of the stock of MORC, the Commissioner computed the gain as if PSLC had sold

(Continued on following page)

entitled to use the cost recovery method of accounting; (3) under the installment method of accounting, which PSLC had elected as an alternative to the cost recovery method, PSLC was required to report a gain in the amount of $464,069 for the taxable year ending May 31, 1979; (4) the $464,069 sum was a capital gain to PSLC in the taxable year ending May 31, 1979; (5) PSLC was a "personal holding company" because more than sixty percent of its adjusted ordinary gross income was from interest because the $464,069 was a capital gain and not ordinary income, and (6) inasmuch as PSLC was a personal holding company it owed an additional $106,832 under the personal holding company tax imposed by I.R.C. § 541.

C. *The Assessment of Deficiencies Against the Prussins*

The Prussins reported a loss of $417,012 from George Prussins' distributive share of the 1978 losses of PSA on their joint federal income tax return for 1978, and a loss of $345,170 from George Prussin's distributive share of

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Summit House to PSA" for $7,759,200. Elsewhere, however, PSLC refers to the $464,069 as "income realized on the sale of real property to its subsidiary by PSLC. . . . " We will not linger on this point as all of the transactions we have described were clearly part of a related program. Furthermore, the parties do not treat the question of which transfer was taxed as significant. We do note that the size of the gain suggests that the transfer to PSA was taxed. We also point out that it was not simply the Commissioner who determined that there was a gain of $3,742,704, as suggested in the quotation, for PSLC reported that gain on its tax return.

PSA's 1979 losses on their 1979 income tax return. On April 22, 1985, the Commissioner issued a deficiency notice to the Prussins entirely disallowing his share of the partnership losses on the ground that the Prussins had not established the amount and character of any of the partnership items on which their individual loss claims were based.

D. *This Litigation*

PSLC and the Prussins brought these actions challenging the Commissioner's deficiency notices. Prior to the consolidated trial, PSLC conceded all issues other than its status as a personal holding company. A trial then ensued before Judge Cohen of the United States Tax Court whose opinion is reported as *Pleasant Summit Land Corporation v. Commissioner*, T.C.M. (CCH) 1987-469 at 566-76 (Sept. 17, 1987) [hereinafter *PSLC*]. Judge Cohen held that PSLC qualified as a personal holding company subject to the personal holding company tax and, accordingly, she upheld the Commissioner's assessment of a $236,840 deficiency for PSLC's taxable year ending May 31, 1979. On this appeal PSLC challenges the Tax Court's finding that PSLC was a personal holding company, though it does not contend that, if it was a personal holding company, the assessment was erroneously calculated.

Judge Cohen determined that the Prussins had deficiencies for their taxable years ending December 31, 1978, and December 31, 1979, respectively, of $264,571.00 and $141,496, attributable to her sustaining the disallowance of deductions that PSA passed through to its limited

partners including the Prussins.[5] The disallowance of PSA's deductions was based on Judge Cohen's factual finding that the nonrecourse debt underlying its purchase of Summit House was greater than its fair market value, which did not exceed $4,200,000. The judge held that as a matter of law nonrecourse indebtedness in excess of fair market value would not support deductions for either depreciation or interest payments as there was no investment in the property and no genuine indebtedness for its purchase. She explained that no depreciable basis in Summit House had been established and consequently no portion of the nonrecourse indebtedness would support tax deductions. On appeal the Prussins challenge Judge Cohen's findings of fact, her application of legal standards, and the constitutionality of the legal standards applied.

II. THE STANDARDS OF REVIEW

This court has plenary review of the Tax Court's construction of the Internal Revenue Code. *See Minizza v. Stone Container Corp.*, 842 F.2d 1456, 1459 (3d Cir. 1988); *Creque v. Luis*, 803 F.2d 92, 93 (3d Cir.1986). This standard of review applies with regard to three issues on appeal. First, it is a question of law whether a single factor test or a multiple factor analysis is employed to determine if a

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[5] In its brief, the Commissioner indicates that the deficiencies were $229,842.80 and $138,112.50. These figures come from the decision of the Tax Court rather than the opinion. On the record before us, we cannot account for this discrepancy but are not required to do so as the deficiencies will in any event be recalculated.

property is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business. Second, it is a question of law whether nonrecourse indebtedness in excess of fair market value may support depreciation and interest deductions. Third, it is a question of law whether deductions based on such indebtedness should be completely disallowed when a taxpayer fails to meet his burden of proof of the fair market value of the property.

The Tax Court's conclusion that the nonrecourse indebtedness on the underlying transaction exceeded the fair market value of Summit House was a finding of fact subject to review for clear error only. *See Anderson v. Bessemer City*, 470 U.S. 564, 573-76, 105 S.Ct. 1504, 1511-12, 84 L.Ed.2d 518 (1985); *Commissioner v. Duberstein*, 363 U.S. 278, 289, 80 S.Ct. 1190, 1198-99, 4 L.Ed.2d 1218 (1960); *B.B. Rider Corp. v. Commissioner*, 725 F.2d 945, 948 (3d Cir. 1984).

PSLC argues that while factual findings are generally subject to review under the clearly erroneous standard, the Tax Court finding that the underlying transaction was not of property held primarily for sale to customers within the ordinary course of its trade or business, constituted an "ultimate fact" subject to plenary review. The Commissioner, however, urges that we accept this finding unless it was clearly erroneous. We have indicated that we no longer recognize the ultimate fact exception to the standard that factual findings are reviewed only for clear error. *American Home Products Corp. v. Barr Laboratories, Inc.*, 834 F.2d 368, 370 n. 2 (3d Cir.1987). Further, the Supreme Court has rejected the ultimate fact exception and has stated that the clearly erroneous standard applies

to findings of ultimate fact. *See Pullman-Standard v. Swint*, 456 U.S. 273, 285-90, 102 S.Ct. 1781, 1788-91, 72 L.Ed.2d 66 (1982). Thus, our earlier decisions permitting plenary review of ultimate fact determinations, *see, e.g., Jersey Land & Development Corp. v. United States*, 539 F.2d 311, 315 (3d Cir.1976); *Pennroad Corp. v. Commissioner*, 261 F.2d 325, 328 (3d Cir. 1958), *cert. denied*, 359 U.S. 958, 79 S.Ct. 797, 3 L.Ed.2d 766 (1959), cannot be taken to represent the present position of this court. Therefore, to the extent that the Tax Court's conclusion regarding the character of the underlying transaction was predicated on a factual finding, it must be accepted unless clearly erroneous. We add, however, that even under a plenary standard of review we would reach the same conclusion as the Tax Court on this issue. Finally, we point out that PSLC contends that, as a matter of law, the undisputed facts require a reversal of the finding in the Tax Court that the sale of Summit House was not of a property held primarily for sale to customers in the ordinary course of PSLC's trade or business. Thus, as we make a plenary determination of legal issues, the dispute over the standard of review is of limited significance in this case.

III. PSLC's APPEAL

Determination of whether PSLC was properly held to be a personal holding company turns solely on whether Summit House was "property held by [PSLC] primarily for sale to customers in the ordinary course of [its] trade or business" within I.R.C. § 1221(1). The Tax Court's opinion provided a clear explanation of the purpose of the personal holding company tax which we need not repeat. We do note that the personal holding company tax

is imposed on all corporations satisfying a mechanical test of objective factors which the Tax Court explained in detail.

A. *The Mechanical Test of the Personal Holding Company Tax*

Section 541 of the Internal Revenue Code imposes an additional tax on undistributed personal holding company income, as defined in section 545, for "every personal holding company (as defined in section 542)." Section 542(a) provides that nay corporation is a personal holding company if it meets mechanical tests relating to the number of stockholders and to the character of income earned during the tax year. Inasmuch as all PSLC stock was owned by one person, PSLC agrees that the stockholder test was met and thus we do not describe that test in detail.

The character of income requirement is contained in section 542(a)(1), which provides that "[a]t least 60 percent of [the corporation's] adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year [must be] personal holding company income (as defined in section 543(a))." This may be expressed as follows: a corporation is a personal holding company if the fraction consisting of personal holding company income as the numerator and adjusted ordinary gross income as the denominator is greater than or equal to sixty percent (60%). Our task in establishing this fraction is simplified by the circumstance that during its applicable tax year PSLC had only two kinds of income, income from interest payments on debts arising from the Summit

House transactions and income from the sale of the Summit House property.

Inasmuch as the parties agree that only the interest payments constituted personal holding company income, the numerator of the fraction is not in dispute. They disagree, however, over calculation of the denominator of the fraction. If the gain from the sale of Summit House is included in the denominator then PSLC is not a personal holding company. But if the gain is excluded then only the interest income is included in both the numerator and the denominator, giving the fraction a value of one or 100% and, since 100% is greater than 60%, PSLC is a personal holding company.

B. *Calculation of the Denominator*

The denominator of the fraction consists of "adjusted ordinary gross income (as defined in section 543(b)(2))." I.R.C. § 542(a)(1). Section 543(b)(2) defines adjusted ordinary gross income as "orindary gross income" subject to certain reductions not applicable to this case.

"Ordinary gross income" is defined by section 543(b)(1)(A) as gross income less "all gains from the sale or other disposition of capital assets."[6] A "capital asset" is defined by section 1221 to include all property of a taxpayer subject to certain specific exceptions. PSLC argues that the exception for "property held by the taxpayer primarily for sale to customers in the ordinary

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[6] There are other exclusions as well but they are not applicable.

course of his trade or business" applies to the Summit House. I.R.C. § 1221(1).

C. *Whether the Sale was Within the Ordinary Course of Trade or Business.*

While the Commissioner recognizes that a pre-trial stipulation provided that PSLC held Summit House exclusively for sale, he contends that the sale was not of an asset primarily held for sale within the ordinary course of PSLC's trade or business. A determination that PSLC's sale of Summit House was not within the ordinary course of its trade or business would result in the exception of section 1221(1) not applying and, inasmuch as PSLC has not argued that any other exception applies, the general rule of section 1221 would govern. Thus, Summit House would be deemed to be a capital asset and the gain on its sale would be excluded from both PSLC's ordinary gross income and adjusted ordinary gross income. Consequently, PSLC's interest income would constitute the only element of both the numerator and denominator giving the fraction a value of one or 100% and PSLC would qualify as a personal holding company.

Thus, it is perfectly obvious that the determination of whether PSLC is a personal holding company turns solely on whether its sale of Summit House was of property held primarily for sale within the ordinary course of its trade or business. PSLC argues that the trial judge's conclusion that its sale of Summit House was not within the ordinary course of its trade or business was clearly erroneous and that, in any event, the Tax Court was required to reach the opposite conclusion as a matter of law.

1. PSLC's Factual Challenge

We have held that determination of whether property is held for sale within the ordinary course of a taxpayer's trade or business is a question of fact. *See Jersey Land & Development Corp.*, 539 F.2d at 315; *Juleo, Inc. v. Commissioner*, 483 F.2d 47, 50 (3d Cir.) (Gibbons, J., dissenting), *cert. denied*, 414 U.S. 1103, 94 S.Ct. 737, 38 L.Ed.2d 559 (1973); *Heebner v. Commissioner*, 280 F.2d 228, 231-32 (3d Cir.), *cert. denied*, 364 U.S. 921, 81 S.Ct. 285, 5 L.Ed.2d 260 (1960).[7] PSLC argues that the Tax Court's finding was clearly erroneous because it was inconsistent with the pretrial stipulation that PSLC held Summit House exclusively for sale.

This stipulation reads as follows:

> On or about June 1, 1978, PSLC purchased a certain piece of real estate located in West Orange, New Jersey, and certain fixtures, equipment, and other personal property located on or used in connection therewith. . . . *Said purchase was made by PSLC with a view towards immediately reselling the buildings and personalty* to its wholly-owned subsidiary, Mount Orange Realty Corp [MORC]. (Emphasis added.)

PSLC relies on the emphasized portion. This language, however, is not inconsistent with the Tax Court's conclusion that PSLC did not establish that the Summit House

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[7] The determination of the taxpayer's primary purpose in holding the property is made as of the time of sale. *Jersey Land & Development*, 539 F.2d at 315. Here, the circumstances were such that PSLC's purpose in holding the Summit House could not have changed in the time between when it acquired the property and sold the shares of MORC.

transaction occurred within the ordinary course of PSLC's trade or business for its does not even mention the point.

Furthermore, PSLC did not present any evidence as to whether it held Summit House primarily for sale to customers within the ordinary course of its trade or business. Since PSLC bore the burden of proof on this issue, *see* Tax Ct.R.P. 142(a); *Helvering v. Taylor*, 293 U.S. 507, 513-15, 55 S.Ct. 287, 290-91, 79 L.Ed. 623 (1935); *Anastasato v. Commissioner*, 794 F.2d 884, 886-87 (3d Cir. 1986), the Tax Court upheld the Commissioner's determination. Judge Cohen pointed out that "[h]ad petitioner chosen to address the issue at trial, it might have submitted evidence demonstrating that the property was held or sold in the ordinary course of PSLC's trade or business. See section 1221(1). Absent such evidence, we cannot find that the property was not a capital asset. Rules 142(a) and 149(b). Respondent's [Commissioner's] determination is sustained." *PSLC* at 573 (citations omitted).

In summary, the stipulation does not state that the Summit House transaction was within PSLC's ordinary course of trade or business and PSLC offered no evidence that it was. Thus, we hold that the Tax Court's factual finding that the sale was not within the ordinary course of PSLC's trade or business was not clearly erroneous.

2. PSLC's Legal Challenge

PSLC nevertheless advances the slightly different argument that, as a matter of law, the stipulated facts required that the Tax Court conclude that sale of Summit

House occurred within the ordinary course of its business. In substance, its argument is that as a matter of law it must be concluded that the purchase of an asset for sale subject to a pre-existing contract of sale *always* results in the acquisition of a property to be held primarily for sale to customers in the ordinary course of trade or business. PSLC argues that the Tax Court erred in failing to follow this single factor approach. If, however, as the Commissioner argues, a court must consider and weigh several factors to make this determination, then PSLC cannot prevail on this theory.

This court addressed the problems involved in determining when a sale occurs during a taxpayer's ordinary course of business in *Jersey Land & Development Corp.*, where we stated:

> Whether or not a taxpayer has held real property for sale to customers in the ordinary course of its business is an issue that has often been litigated in the federal courts. Despite this volume of litigation, however, *there is no fixed formula or rule of thumb to which a court may readily resort for guidance in resolving this issue.* Rather, each case must, by necessity, turn upon its own facts since *this question is, in the final analysis, one of fact to be determined from the totality of the circumstances surrounding each particular case.* [539 F.2d at 315 (emphasis added.)]

This fact-specific approach in *Jersey Land & Development* was consistent with our precedents. *See Heebner v. Commissioner*, 280 F.2d at 232; *Kaltreider v. Commissioner*, 255 F.2d 833, 838 (3d Cir. 1958). The Tax Court has followed this approach and it is now stated that the determination "[w]hether income from the sale of property is

excluded from capital gains treatment is a question of fact, the burden of which is on [the taxpayer]." *S & H, Inc. v. Commissioner*, 78 T.C. 234, 242 (1982) *see Baumgart v. Commissioner*, 47 T.C.M. (CCH) 592, 598, 52 T.C.M. (P-H) 3095, 3101 (1983) [available on WESTLAW, 1983 WL 14727].

The characterization of the income from the sale of Summit House is a question of fact depending partially on PSLC's intent with respect to its business activities. *See Baumgart*, 47 T.C.M. (CCH) at 596, 52 T.C.M. (P-H) at 3099. Several cases have identified a number of factors to be considered in this analysis.[8] The factors most frequently identified are: (1) the purpose for which the taxpayer acquired and held the property; (2) the extent of improvements made to facilitate its sale; (3) the activity of the taxpayer in promoting the sales; (4) the frequency and continuity of sales; (5) the extent and substantiality of sales; (6) the length of time between purchase and sale; and (7) the relative income to the taxpayer from the sale of the property, compared with his other income. *See Baumgart*, 47 T.C.M. (CCH) at 598, 52 T.C.M. (P-H) at 3101; *S & H*, 78 T.C. at 243 n. 12. This court has enumerated and relied on these factors. *See Kaltreider*, 255 F.2d at 838.

PSLC has not cited any controlling authority to suggest that we have departed from this multi-factor analysis. PSLC does, however, cite *S & H. Morley v.*

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[8] This court has observed, however, that while these factors may be helpful in analyzing residential real estate transactions, they are of limited utility when commercial real estate is involved. *See Jersey Land & Development*, 539 F.2d at 316.

Commissioner , 87 T.C. 1206 (1986), *Baumgart*, and *DeMars v. United States*, 71-1 U.S. Tax Cas. (CCH) ¶ 9288, at 86,114, 27 A.F.T. R.2d (P-H) ¶ 71-490, at 71-925 (S.D.Ind. 1968) [available on WESTLAW, 1968 WL 170], for the proposition that when a taxpayer purchases real estate for sale to a specific party under a pre-existing contract, it holds the property primarily for sale to customers in the ordinary course of business regardless of other factors or facts.

S & H and *Morley* do not stand for the stated proposition Like our case, those cases involved a taxpayer's single venture and determination of whether the property involved was held primarily for sale to customers within the ordinary course of the taxpayer's trade or business. *S & H* and *Morley* merely rejected adoption of an absolute prohibition precluding the court from determining that a unique undertaking was within the scope of the taxpayer's trade or business with respect to that single transaction. As *Morley* explained, *S & H* "rejected the so-called 'one-bite' rule to the extent that such rule established that 'a taxpayer who engaged only in one venture or one sale *cannot under any circumstances* be held to be in a trade or business as to that venture or sale.' " *Morley*, 87 T.C. at 1211 (*citing S & H*, 78 T.C. at 244 (emphasis added)). By rejecting a *per se* rule, the Tax Court in *Morley* and *S & H* reaffirmed that this is an issue of fact in which no one fact or factor is dispositive. *See Morley*, 87 T.C. at 1213.

DeMars and *Baumgart*, however, do go further and state a *per se* rule, "that property acquired for the purpose of sale to a specific party pursuant to a pre-existing arrangement constitutes property held for sale in the

ordinary course of a trade or business." *DeMars*, 71-1 U.S.Tax Cas. (CCH) ¶ 9288 at 86,117, 27 A.F.T.R.2d (P-H) ¶ 71-490, at 71-929. We, however, decline to follow these cases as we have previously stated that "[n]o single factor or test is dispositive." *Kaltreider*, 255 F.2d at 838. Thus, we reaffirm our conclusion that whether a property is held primarily for sale to customers within the ordinary course of a taxpayer's trade or business is a fact specific question for which no single factor is dispositive. Here the finding of fact by the Tax Court on the issue was not clearly erroneous and thus must be upheld. In any event, on an independent review of the record we would reach the same result because of the lack of evidence that the transaction involved a property held primarily for sale to customers in the ordinary course of PSLC's trade or business. Thus, we will affirm the judgment of the Tax Court on PSLC's appeal.

IV. THE PRUSSINS' APPEAL

The Prussins, as limited partners in PSA, claimed a deduction for their distributive share of PSA's depreciation and interest deductions which the Commissioner, upheld by the Tax Court, completely disallowed. Three issues are raised with respect to the Tax Court's decision on this point. First, we consider whether PSA's purchase of Summit House, and not the individual limited partners' investment in PSA, is the appropriate transaction for examination. Second, we must decide whether the Tax Court's finding of fact that PSA's nonrecourse indebtedness substantially exceeded the fair market value of Summit House was clearly erroneous. Third, we must consider which of the following approaches should be

followed: (1) the excess nonrecourse indebtedness may support the claimed deductions; (2) the presence of excess nonrecourse indebtedness requires a complete disallowance of the claimed deductions; or (3) only deductions attributable to the nonrecourse indebtedness to the extent that it was excessive should be disallowed.

A. *The Relevant Inquiry Takes Place at the Partnership Level*

The Prussins urge that we consider the transaction from the perspective of the individual limited partners who did make substantial cash contributions for their investments. But a partnership is required to file its own federal income tax return. Accordingly, for the purpose of computing income and deductions, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners." *United States v. Basye*, 410 U.S. 441, 448, 93 S.Ct. 1080, 1085, 35 L.Ed.2d 412 (1973); *accord Brannen v. Commissioner*, 722 F.2d 695, 703 (11th Cir.1984). After the partnership's income and deductions are calculated and reported it is a conduit through which income and deductions are distributed to individual partners. *See Brannen*, 722 F.2d at 703; *Goodwin v. Commissioner*, 75 T.C. 424 (1980), *aff'd without published opinion*, 691 F.2d 490 (3d Cir.1982). Thus, inasmuch as the Prussins claim losses from the Summit House transaction because of George Prussin's limited partnership interest in PSA, we must make our analysis of the investment from the point of view of the partnership. *See Simon v. Commissioner*, 830 F.2d 499, 506-07 (3d Cir.1987). This conclusion renders immaterial the Prussins' argument which, predicated on the investment of the limited partners, is

that this transaction should be regarded as an at risk rather than a nonrecourse transaction.

B. *Whether PSA's Nonrecourse Indebtedness Exceeded the Fair Market Value of Summit House*

If we assume, even though the record is unclear on this point, that PSA paid the $500,000 which MORC was to have paid to PSLC, PSA's purchase price for Summit House was $7,759,200 of which no more than $500,000 was paid other than by creation of nonrecourse indebtedness. Otherwise it was $7,259,200. It is this investment which must be compared to the fair market value of Summit House.

The Prussins challenge Judge Cohen's finding of the maximum fair market value. At trial they had the burden of proof on the issue. Tax Ct.R.P. 142(a); *see Helvering v. Taylor*, 293 U.S. at 513-15, 55 S.Ct. at 290-91; *Anastasato v. Commissioner*, 794 F.2d at 886-87. But they introduced no significant evidence of valuation and they produced no expert testimony on this point.[9]

While normally the parties to a real estate transaction have adverse economic interests and thus can be expected to establish fair market value themselves, Judge Cohen explained that here "[s]ales subsequent to PSLC's acquisition of the property . . . were not at arm's length,

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[9] Judge Cohen observed that Tax Court Rule of Procedure 143(f) and a pretrial standing order required the taxpayers to present an expert report but that the taxpayers decided to forego expert testimony on the value of Summit House. *See PSLC* at 574 & n. 6.

and provide no evidence of the property's fair market value." *PSLC* at 575. This determination rested on her perception of the motivation for the conveyances: "in a transaction entered into primarily to generate tax benefits, the interests of the buying and selling parties are not necessarily adverse." *PSLC* at 575.

The Prussins challenge this line of reasoning by asserting that not paying money out is almost *always* better than getting a deduction. Thus, PSA would not pay an excessive amount for the property. While their reasoning is generally true, the Tax Court cited PSA's own projected tax benefits to demonstrate that this transaction did indeed provide deductions sufficient to compensate for the additional money paid out. *See PSLC* at 570. In addition, there was no evidence that PSA had attempted to negotiate the sales price. We conclude that Judge Cohen was justified in considering indications other than what PSA paid to determine the fair market value of Summit House.

The Tax Court did consider the following indicia of fair market value: (1) PSLC had paid $4,200,000 for the improvements *and the land* in an arms length transaction immediately before selling the improvements to PSA for over $7,700,000, *see PSLC* at 573-76; (2) the assessed value of the improvements for property tax purposes suggested a fair market value of $1,522,500;[10] (3) the improvements

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[10] The Tax Court relied on the assessed value and the municipality's stated relationship between the assessed value and fair market value. The assessed value had been presented by PSA to its investors in its initial offering memorandum. *See*

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were insured for $2,745,000;[11] and, (4) the improvements and land were sold in 1985 for $7,000,000.

The Prussins argue that the Tax Court erroneously ignored oral testimony regarding the anticipated increase in value of Summit House provided it could be marketed as originally envisioned as cooperatives or condominiums, a purpose frustrated by a change of local law. We, however, see no reason to accept this assertion in view of Judge Cohen's analysis of the evidence in the record. Further, the facts of this case demonstrate the peril in relying on anticipated changes in a property to support an enhanced value. In short, Judge Cohen did not have to reject solid evidence showing a maximum fair market value because of a speculative projected new use.

The Prussins erroneously assert that Judge Cohen held that PSLC's purchase price was conclusive of fair market value in PSA's subsequent purchase. She, however, did not hold that Summit House could be worth no more to PSA than PSLC had paid for the property. What she did hold was that the Prussins had failed to meet their burden of proof on value and that only the sale to PLSC on the record provided evidence of the value of Summit House. Furthermore, she did not find that fair

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PSLC at 575. Judge Cohen considered and rejected the Prussins' contention that PSLC's purchase price was for less than the fair market value. This finding was not clearly erroneous.

[11] The replacement value of the buildings, not the land, was insured for this value under a policy containing a 90 percent coinsurance clause. *See PSLC* at 574.

market value was $4,200,000; she concluded that fair market value could not have been more than that sum. *See PSLC* at 575.

Given her consideration of many different bases for finding fair market value and the Prussins' failure to present expert testimony on value, we conclude that Judge Cohen's findings as to the maximum fair market value were not clearly erroneous. Accordingly, we will not disturb her finding that the nonrecourse financing exceeded the fair market value of Summit House.

C. *The Appropriate Legal Standard*

The Internal Revenue Code does not expressly provide in any section germane to this case for any adjustment of deductions when nonrecourse debt exceeds fair market value.[12] Thus, it is necessary to analyze the overall statutory framework and legal precedents to understand the significance of the Tax Court's finding that PSA's nonrecourse debt exceeded the fair market value of Summit House.

1. The Statutory Framework

The Internal Revenue Code allows a deduction for "a reasonable allowance for the exhaustion, wear and tear" of property used in the taxpayer's trade or business and of property held for the production of income. I.R.C.

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[12] The at risk provisions of the Internal Revenue Code of 1954 do not govern this case. *See* I.R.C. § 465 as amended by the Revenue Act of 1978, Pub.L. No. 95-600, § 201, 92 Stat. 2763, 2814-15 (1978).

§ 167(a). This depreciation deduction is calculated using the adjusted basis of the property used to calculate gain under section 1011. *See* I.R.C. § 167(g). The basis of the property for purposes of calculating gain under section 1011 is ultimately defined in section 1012. Section 1012 provides that generally the "basis of property shall be the cost of such property."

The cost of property includes the amount of indebtedness incurred or assumed by the purchaser as part of the purchase transaction. *See Crane v. Commissioner*, 331 U.S. 1, 9-10, 67 S.Ct. 1047, 1052-53, 91 L.Ed. 1301 (1947). However, several courts of appeals have held that nonrecourse debt in excess of fair market value is not included in the cost of property for purposes of calculating the depreciation deduction. *See, e.g., Odend'hal v. Commissioner*, 748 F.2d 908, 912-14 (4th Cir.1984), *cert. denied*, 471 U.S. 1143, 105 S.Ct. 3552, 86 L.Ed.2d 706 (1985); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976).

Section 163(a) of the Internal Revenue Code allows a deduction for all interest paid or accrued within the taxable year on indebtedness. This provision allows a deduction for interest paid on nonrecourse debt. It has been held, however, that when "both the purchase price and the lesser principal amount of the nonrecourse note which makes up a portion of such purchase price unreasonably exceed the value of the property acquired, then no 'genuine indebtedness' exists and no 'investment in the property' occurs." *Flowers v. Commissioner*, 80 T.C. 914, 942 (1983); *see also Odend'hal*, 748 F.2d at 912-14; *Estate of Franklin*, 544 F.2d at 1049.

Although separate statutory provisions govern interest and depreciation deductions, the case law typically merges issues relating to their allowance. Thus, when nonrecourse debt is excluded from the basis for purposes of calculation of depreciation, it is not treated as genuine indebtedness for determination of interest deductions.

2. Whether the Nonrecourse Indebtedness is Included In PSA's Basis and Whether it is "Genuine Indebtedness"

Although this court has not previously addressed this issue,[13] decisions of other courts of appeals have disallowed deductions for interest and depreciation in circumstances similar to those here. Some of these cases specifically involve investments in real estate and improvements.[14]

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[13] In *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir.1982), *cert. denied*, 462 U.S. 1106, 103 S.Ct. 2453, 77 L.Ed.2d 1333 (1983), we held that we would not require the Commissioner to permit contingent or speculative obligations to be included in the basis while the uncertainty surrounding them was unresolved. *CRC*, like *Brountas v. Commissioner*, 692 F.2d 152 (1st Cir.1982), *cert. denied*, 462 U.S. 1106, 103 S.Ct. 2453, 77 L.Ed.2d 1333 (1983), and *Gibson Products Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981), on which it relied, should thus be regarded as timing cases and, while wholly consistent with our result, are not sufficient authority on which to basis our decision.

[14] The Prussins argue that cases involving wasting assets are inapplicable to real estate investments. The Prussins rely on *Siegel v. Commissioner*, 78 T.C. 659, 690 (1982), to demonstrate that the Tax Court recognizes the distinction between

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Of the cases decided by other courts of appeals, that most similar to this case is *Odend'hal v. Commissioner*, 78 F.2d 908. *Odend'hal* stands for the proposition that if the fair market value of property is less than its nonrecourse financing, the principal of the nonrecourse financing in excess of fair market value is not included in the basis for the purpose of claiming depreciation. Moreover, *Odend'hal* holds this excess nonrecourse debt does not sustain a deduction for interest payments.

The facts of *Odend'hal* were as follows. Ten taxpayers purchased a warehouse and food processing facility. As in this case, the taxpayers acquired only the improvements and a long term lease on the land.[15] The purchase took place in December of 1972 for a total consideration of $4,000,000 of which $80,000 was paid in cash and $3,920,000 was financed by nonrecourse debt. Interest on the nonrecourse debt was to be serviced currently but the principal was due in a balloon payment at the end of a fifteen year period.

The promoter of this investment represented that based on a depreciable lifespan of fourteen-and-a-half years, the income earned from leasing the property

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wasting assets and realty when determining whether excess debt should be added to basis. *Siegel* involved a limited partnership investment in a motion picture and thus to the extent it addresses the treatment of real estate, the portion of *Siegel* relied on by the Prussins is dictum. The actual holding of *Siegel* is not inconsistent with our result but even if it was we would not be bound by it.

[15] The lease at the lessees' option was for 99 years. Here it was for 90 years.

would not equal the total of the cost of leasing the land, mortgage interest, and depreciation. However, he explained that the interest and depreciation deductions would generate additional tax benefits so that an investor in the 50% tax bracket would convert the investment income loss into an after-tax gain.

Although the taxpayers purchased the property for $4,000,000, the Tax Court concluded that its fair market value was only $2,000,000. Because of the wide discrepancy between the face value of the nonrecourse debt and the fair market value, the Tax Court held that the nonrecourse note did not represent genuine indebtedness. Thus, it did not allow the taxpayers to include the nonrecourse debt in their basis for purposes of depreciation. In addition, the taxpayers were allowed to deduct interest and other expenses only to the extent of their income from the property.

The taxpayers appealed to the United States Court of Appeals for the Fourth Circuit, arguing that the Tax Court's determination of fair market value was clearly erroneous and that, as a matter of law, the Tax Court was bound to recognize the entire nonrecourse indebtedness when computing depreciation and interest deductions. The Court of Appeals rejected both contentions.

In finding that the Tax Court's valuation of the property was not clearly erroneous, the Court of Appeals relied, in part, on the fact that the same property had been conveyed for $2,670,000 in an arm's length sale five years before it was sold to the group of ten taxpayers. *See id.* at 911-12. Once the fair market value was established

the court turned to the issue of the excessive nonrecourse debt. It stated:

> If, as a matter of fact, the fair market value of the property is less than that financed by a nonrecourse loan, the authorities hold that the principal of the nonrecourse loan which exceeds fair market value does not represent a real investment in the property by a taxpayer and he may not include that nonrecourse amount in his basis for depreciation. In addition, the interest paid on the loan is not allowable as an interest deduction. Basis for depreciation usually includes the amount of any indebtedness incurred or assumed by the purchaser in connection with the purchase of the property, because the taxpayer has an obligation to pay the debt. When the debt is a nonrecourse loan, the principal amount of the loan is included in the taxpayer's basis so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral. But if the stated price financed by nonrecourse debt exceeds the fair market value of the property, to the extent of the excess, the taxpayer has no equity in the property to protect and no economic incentive to pay off the debt. [*Id.* at 912.] (Citations omitted.)

Under this analysis taxpayers are able to claim depreciation and interest deductions to the extent that nonrecourse debt does not exceed fair market value.

Odend'hal ultimately relied on *Estate of Franklin*, 544 F.2d 1045, which imposed similar limits on deductions supported by nonrecourse debt. In *Estate of Franklin* the owner of a motel agreed to sell it for $1,224,000 with the entire purchase price to be paid by a note secured by a nonrecourse mortgage with monthly principal and interest installments of $9,045.36. A balloon payment of $975,000 was due ten years from the sale. The property was leased back to the seller for a monthly rental equal to the $9,045.36 monthly debt service. The seller was responsible for operating the motel and paying all expenses. The buyers' only cash payment was $75,000 of prepaid interest.

The buyers claimed that they could take interest and depreciation deductions for the ten years and then either make the balloon payment and complete the purchase or back out of the purchase. The Tax Court characterized this transaction as a ten year option to purchase and accordingly disallowed the deductions for interest and depreciation.

The Court of Appeals for the Ninth Circuit considered the case from a different perspective. It held that if the transaction met two criteria it would not be considered a sale for tax purposes and thus no interest or depreciation deductions would be allowed. The first test was whether the value on which the transaction was based exceeded the fair market value of the property. The second factor was whether the transaction was financed with nonrecourse debt which exceeded the fair market value of the underlying property. The Court of Appeals concluded that the transaction in *Estate of Franklin* met these two criteria and thus it affirmed the Tax Court.

The Prussins attempt to distinguish *Odend'hal* and *Estate of Franklin* on two rationales. First, they argue cash represented only three percent of the purchase price in *Odend'hal* and just over six percent of the purchase price in *Estate of Franklin*, as opposed to their own more substantial investment in PSA. Second, they contend the large balloon payments in *Odend'hal* and *Estate of Franklin* demonstrate that the transactions were mere options to purchase and that here there are no such balloon payments.

Each of these attempts to distinguish *Odend'hal* and *Estate of Franklin* must fail. With regard to the first objection, the appropriate comparison with *Odend'hal* and *Estate of Franklin* is the proportion of cash to nonrecourse debt paid by PSA rather than the amount of the individual limited partners' cash investments. Based on a purchase price of $7,759,200 and a $500,000 cash payment, assuming it was made, this calculation would indicate that 6.44% of the purchase price was paid in cash. This analysis reveals the similarity of this case to the precedents rather than providing a basis to distinguish them. Of course, the Prussins' argument is even weaker if the $500,000 was not paid.

The Prussins' second rationale partially misstates the terms of PSA's obligations. As we have indicated, principal payments on the mortgages were substantially postponed.[16] But even if they were not, it is the existence of deferred nonrecourse indebtedness in excess of the value

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[16] We have so concluded on the basis of our study of notes and mortgages in the record. We point out, however, that the Commissioner makes no mention of this point in his brief.

of the property that creates the economic disincentive to pay the debt. While there may be less incentive to make a balloon payment at the end of a term as compared with earlier structured payments, the proper analysis must be predicated on a comparison of the nonrecourse debt to the fair market value of the property at its acquisition.

The Prussins attempt to distinguish other cases applying *Estate of Franklin* to real estate investments. Both *Beck v. Commissioner*, 678 F.2c. 818 (9th Cir.1982), and *Narver v. Commissioner*, 75 T.C. 53 (1980), *aff'd per curiam*, 670 F.2d 855 (9th Cir. 1982), are supposedly inapplicable in light of the small percentage of the purchase price paid in a form other than nonrecourse debt and the great overvaluing of the property. But the Prussins' attempt to distinguish these cases must fail for the same reason that *Odend'hal* and *Estate of Franklin* cannot be distinguished: that is, the Prussins are not comparing the same parts of the different transactions as they are looking to the limited partners' investment rather than that of PSA. The Summit House purchase price was substantially paid by PSA with nonrecourse obligations.[17]

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[17] The Prussins challenge the entire *Estate of Franklin* line of cases by pointing out that inasmuch as this is a limited partnership case, the Commissioner's reliance on the nonrecourse aspect of the transaction is "completely misplaced" as the limited partners were not liable anyway. We do not agree, because the legal insulation of the limited partners in no way would impact on the incentive of the general partner to pay a recourse obligation. Thus, their argument on this point incorrectly looks at the transaction from the wrong perspective. As we have indicated, the relevant inquiry takes place at the

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While we regard *Odend'hal* and *Estate of Franklin* as the appropriate precedents, we do not consider them as authority to eliminate all deductions for interest and depreciation. While we realize that a taxpayer holding property subject to a nonrecourse debt in excess of the market value of the property may have no incentive to pay off any portion of the debt, including the amount not exceeding the fair market value of the property, it is equally logical to recognize that the creditor holding the debt has no incentive to take back the property if the taxpayer offers to pay the debt up to the value of the property. For example, if a creditor held a nonrecourse debt for $1,500,000 on a property with a fair market value of $1,000,000, he would have a disincentive to foreclose if his defaulting debtor offered to settle the debt for not less than $1,000,000. Thus, it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded. Moreover, there is precedent for disallowing deductions based on nonrecourse debt only insofar as attributable to the excess of debt over the fair market value. *See Odend'hal*, 748 F.2d at 912-14.

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partnership level. Their argument may actually cut the other way as in a limited partnership recourse note situation it could be contended that the *Estate of Franklin* rationale should be followed if the debt is excessive as compared to the value of the property and the general partner is not financially responsible.

Unquestionably, the record compels the conclusion that Summit House, though not exceeding $4,200,000 in fair market value, had a substantial value. Thus, under our analysis the Tax Court's determination that the deductions should be disallowed in full cannot be sustained. Accordingly, we will remand the case to the Tax Court for a determination of fair market value of Summit House at the time of PSA's acquisition.[18]

We also conclude that the actual cash investment of PSA in the purchase of Summit House, if there was any, should be disregarded in the calculation of the fair market value as it obviously was at risk. While Judge Cohen inferred that the $500,000 was not paid by PSA, we are not satisfied that this was necessarily correct, particularly in view of the Commissioner's brief in which it is recited that it appears that the $500,000 was paid from the investor's funds. According to the Prussins, the absence of

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[18] While Judge Cohen indicated that "the fair market value of the property could not have been more than $4,200,000," *PSLC* at 575, she may have concluded that it was $4,200,000, though her opinion does not include a definitive finding on the point. We, however, doubt that she did intend to determine the fair market value as distinguished from the maximum fair market value, as the $4,200,000 figure came from the price to PSLC which included the land and improvements and PSA by purchasing MORC acquired only the improvements. If, however, we misunderstand her findings on this point, the fair market value need not be reconsidered. We also point out that while we are remanding the case for calculation of the fair market value, the Prussins will be limited to a maximum value of $4,200,000, as we are upholding the finding that the fair market value did not exceed that figure.

evidence establishing that the $500,000 was paid is attributable to the fact that there was no issue at trial raised regarding this point. On the remand it may be definitively ascertained whether the payment was made. The significance of the cash investment is that there is an economic reason to pay off a nonrecourse debt when there is some equity in the property, even though the total debt when added to the equity exceeds the value of the property, as the alternative to paying the debt is the loss of the equity. Thus, if there is a $500,000 equity in a property worth $4,000,000, the owner of the property should logically be willing to pay off up to $4,000,000 in nonrecourse debt to save the property because his loss in that case will not exceed $500,000 but his loss in giving up the property will be $500,000.

The Prussins' constitutional challenge is based on a contention that they were denied due process of law by the total disallowance of the deductions. Thus, they do not assert that the result we reach would deny them due process of law. Accordingly, their constitutional argument is moot and will not be considered.

V. CONCLUSION

In summary, we hold that PSLC failed to establish that it held Summit House primarily for sale to customers in the ordinary course of its trade or business. Hence, the decision of the Tax Court with respect to PSLC will be affirmed. We hold that the Tax Court's finding that PSA's nonrecourse debt exceeded the fair market value of Summit House was not clearly erroneous and will not be disturbed. We also hold that PSA's nonrecourse debt did

not support interest and depreciation deductions to the extent it exceeded the sum of the cash investment of PSA in Summit House and the fair market value of Summit House at the time of its purchase. We will partially reverse the decision as to the Prussins and will remand the matter to the Tax Court for a determination of the fair market value of Summit House, the actual cash investment, if any, made by PSA for the purchase of Summit House, and for further proceedings consistent with this opinion which will partially allow the interest and depreciation deductions claimed by them.

OPINION

GREENBERG, Circuit Judge.

The Commissioner filed a petition urging this panel of the court to reconsider our opinion filed on November 25, 1988. Although we will deny the petition we will address several of the Commissioner's arguments.

As framed by the Commissioner the issue meriting rehearing is:

> Whether a taxpayer who has acquired property subject to nonrecourse indebtedness that is far larger than the fair market value of the property at the time of acquisition is entitled to deductions for interest and depreciation attributable to the nonrecourse indebtedness to the extent of the fair market value of the collateral.

Our opinion answered this question in the affirmative.

The Commissioner petitions for reconsideration on two bases. First, he objects to our reading of several

precedents upon which we rely as persuasive authority. Second, the Commissioner argues that our opinion will create valuation problems which will produce intolerable administrative burdens.

The Commissioner's first argument refers to our reliance on *Odend'hal v. Commissioner*, 748 F.2d 908 (4th Cir.1984), *cert. denied*, 471 U.S. 1143, 105 S.Ct. 3552, 86 L.Ed.2d 706 (1985) and *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir.1976). He argues that the courts in these cases disallowed *any* depreciation or interest deductions rather than disallowing only deductions attributable to the excess nonrecourse debt. Accordingly, he contends that we should disregard the language in each of the opinions suggesting the contrary result.

We observe, however, that in both *Odend'hal* and *Estate of Franklin*, as the Commissioner seems to acknowledge, the issue of whether the taxpayers were entitled to a partial deduction was apparently not raised either before the Tax Court, *see Odend'hal v. Commissioner*, 80 T.C. 588, 590, 602-05, 617-18 (1983); *Estate of Franklin v. Commissioner*, 64 T.C. 752, 760-62, 770-71 (1975), or on appeal, *see Odend'hal*, 748 F.2d at 909, 912, 913; *Estate of Franklin*, 544 F.2d at 1046, 1048-49. In this case the issue was squarely presented to the court, and thus we were required to rule on it. We found the opinions and reasoning in *Odend'hal* and *Estate of Franklin* persuasive while we found their holdings, which did not directly address this issue, not in opposition. Indeed, the Commissioner acknowledges in his petition for rehearing that "[t]o be sure, there is language in the opinions in both

Odend'hal and *Estate of Franklin*, which, taken out of context, could be read as consistent with the panel opinion here."

The Commissioner's second argument is based on a misreading of our opinion. The Commissioner correctly notes that we call "for the taxpayers to use the fair market value of the property on the date of purchase in determining how much of the nonrecourse debt to allow in calculating their basis in the property." However, the Commissioner suggests that we would allow annual recalculations of the portion constituting genuine indebtedness "because [the taxpayers] have an incentive to repay a greater amount of the nonrecourse debt each year." Accordingly, the Commissioner observes that these recalculations would impose administrative burdens and produce "computational anarchy". We cannot perceive how the Commissioner arrived at this understanding as we said that "it is appropriate to disregard only the portion of nonrecourse debt in excess of the fair market value of the property *when it was acquired* for purposes of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded." Panel opinion, *supra*, at 277-78 (emphasis added.) We never suggested that there would be annual reevaluations. Thus, the administrative burdens which the Commissioner contemplates do not exist. However, to clear up any possible misunderstanding, we now expressly state that our opinion of November 25, 1988, is not to be read to require periodic recalculations of the sum of nonrecourse debt constituting genuine indebtedness.

The Commissioner argues in support of his second basis for rehearing that "a borrower whose note exceeds a reasonable estimate of the fair market value of the property has no immediate incentive to pay off any part of the note, because his payments will not give him any equity in the property unless and until the value of his interest exceeds the face amount of the note." In this regard the Commissioner points out that "the investor's entitlement to the claimed tax benefits" is fixed at the time the property is acquired. But if the lender is rational the borrower does have an incentive to pay off a portion of the debt for the lender has a disincentive to foreclose if the purchaser offers to pay the debt up to the value of the property. While the Commissioner dismisses the compromise possibility as "entirely speculative" and "wholly unpredictable at the time the borrower acquires the property subject to the non-recourse note" his argument proves too much because the concept of disallowance of the deductions in excess non-recourse financing situations is based on the theoretical economic disincentive to the borrower to pay the debt rather than upon what ultimately happens. It is no more speculative to assume that the lender will act rationally in compromising than it is to assume that the borrower will not foolishly pay the entire nonrecourse debt. We said as much in our original opinion and we see no reason to change our conclusion in this regard.

The Commissioner's Petition for Rehearing will be denied.